

DEFERRED ANNUITIES

Deferred annuities are of two types: fixed rate and variable.

FIXED RATE ANNUITIES

The major shortcoming of a fixed rate annuity is that it is only as secure as the insurance company that sponsors it. That is because the annuity holder's money is commingled with the other assets of the insurance company. From the point of view of safety, money in a fixed rate annuity is comparable to money in a bank that is not insured by the Federal Deposit Insurance Corporation (FDIC). For this reason alone it may not be prudent for individuals subject to anxiety over the safety of their savings to hold money in a fixed rate deferred annuity. Given the many revelations of the shaky finances of previously revered insurance companies, and the subsequent insolvency of some, the advisability of avoiding this particular kind of risk may be still further indicated.

VARIABLE ANNUITIES

Variable annuities are a different breed of cat. They are insurance contracts invested in mutual fund-type vehicles called "sub-accounts." Though the value of a sub-account fluctuates with the securities market in which it is invested, its viability is not dependent upon the financial health of the sponsoring insurance company. The assets in a sub-account are segregated from the assets of the insurance company, and so even bankruptcy of the insurance company should not affect its integrity.

If one elects a deferred annuity, then, the variable annuity seems the way to go. If one is not comfortable investing in the stock market, he can put his money in a sub-account that invests in bonds; if he wants the utmost in safety in bonds, he can select a U. S. Government bond sub-account; and, if he wants the greater stability of cash-type investments, he can select a money market sub-account. There are many other investment options, and one's annuity money can be allocated among different sub-accounts and re-allocated from time to time.

THE IRONY OF THE INCOME TAX DEFERRAL

The real purpose of this paper, however, is to demonstrate that the most heavily merchandised feature of deferred annuities - the deferral of taxes on income until the money is withdrawn - when compared to the cost of ownership of the deferred annuity vehicle is, for most holders, a less-than-worthless attribute.

If we purchase a deferred annuity, we pay no income tax on what our money earns until we withdraw the money. When we withdraw the money, we pay a regular income tax on the accrued income but no tax on our original investment. In comparison, if we are invested with an account that is not tax-deferred, we must pay ongoing income and capital gains taxes; the act of withdrawal, however, does not, itself, trigger a tax.

The first downside to variable annuities is their ongoing costs of ownership. To measure these costs we need only compare the rates of return on deferred annuity sub-accounts with the rates of return on the markets in which these sub-accounts are invested

Variable annuity sub-accounts (and mutual funds) have historically and consistently underperformed the markets in which they invest. This underperformance is attributable, in part, to the various ongoing fees and expenses associated with maintaining the vehicles but, more significantly, to "market impact" costs or concessions in the prices they must accept as a result of the large size of the positions they must trade when they buy or sell.

Though both mutual funds and sub-accounts are charged fees for management and other services that they require in common, and though mutual funds may have some expenses associated with them that sub-accounts do not, there are more significant expenses charged against sub-accounts that mutual funds do not carry. They include an annual mortality and expense risk (M&E) charge of about 1.25% per year and an additional administrative fee of about 0.15% per year to cover costs involved in offering and administering the variable annuity, such as for printing and distributing correspondence.

In any event, the magnitude of the underperformance of deferred variable annuity sub-accounts, relative to the markets in which they were invested, over the ten-year period ending December 31, 1998, appears in the following table:

TABLE I
AVERAGE ANNUAL TOTAL RATES OF RETURN FOR 10 YEARS ENDING DECEMBER 31, 1998

<u>Investment Category</u>	<u>Direct Ownership</u>	<u>via Variable Annuity</u>	<u>Average Annual Shortfall</u>
Cash	6.03% ¹	4.11% ²	1.92%
Bonds	11.46% ³	6.41% ⁴	5.04%
Stocks	19.21% ⁵	14.02% ⁶	5.19%
Stocks (Historical)	11.38% ⁷	6.19% ⁸	5.19%

¹Solomon Brothers Index of 6-Month CDs ²Wiesenberger Index of Money Market Variable Annuities ³Lehman Brothers Index of Long U. S. Government Bonds ⁴Wiesenberger Index of All Fixed Income Variable Annuities ⁵Standard & Poor's 500 Composite Index ⁶Wiesenberger Index of All Equity Variable Annuities ⁷Ibbotson Associates Large Company Stock Index for 73-year period 1926-1998 ⁸Assuming the same 5.19% shortfall as for the 10-year period.

The fourth investment category has been added in the above table, based on the more conservative assumption that the stock market will not continue to deliver the 19.21% per year return it has averaged over the past ten years. For a more realistic scenario, the stock market's average return over the past 73 years is used, but the same 5.19% shortfall as for the past ten years for variable annuities is assumed. Deferred annuities have not been around for 73 years, and so we do not have the longer-term data on them. It seems reasonable to assume, however, that their level of expenses, and so the 5.19% shortfall, may remain relatively constant over all types of markets.

The magnitude of the variable annuity deferral advantage (or disadvantage) for the individual owner depends upon his income tax bracket—both federal and state. For purposes of illustration, we have tested for combined federal and state income tax rates of 20%, 30%, 40%, and 50%.

The formula for the amount of after-tax dollars we have at some future point in time, if we invest a dollar today in an account that is not tax-deferred, is as follows:

$$[1+R(1-T)]^n$$

where R = before-tax rate of return, T = tax rate, and n = the number of years.

The formula for the amount of after-tax dollars we have at some future point in time, if we invest a dollar today in a tax-deferred variable annuity, is as follows:

$$1+(1-T)[(1+R)^n-1]$$

With the aid of a computer, we have input the data in the table above for the four investment categories and for each of the four tax brackets to determine how long it would be necessary to hold the variable deferred annuity to produce the same after-tax return as investing in the same category without the benefit of the tax deferral. Our findings were as follows:

TABLE II
YEARS BEFORE AFTER-TAX RETURN ON DEFERRED ANNUITY EQUALS
AFTER-TAX RETURN ON DIRECT INVESTMENTS

<u>Investment Category</u>	<u>Assumed Combined Federal & State Income Tax Rate</u>			
	<u>20%</u>	<u>30%</u>	<u>40%</u>	<u>50%</u>
Cash	Never	Never	106 Years	57 Years
Bonds	Never	Never	Never	Never
Stocks	Never	71 years	22 years	14 years
Stocks (Historical)	Never	Never	Never	147 years

OTHER CONSIDERATIONS

But even the foregoing calculations fail to reveal all of the shortcomings of owning a deferred annuity. In addition, the following factors should be considered.

- (1) In the case of common stocks in an account that is not otherwise tax-deferred, the preceding formula for future after-tax dollars makes the unrealistic assumption that all capital gains are realized and taxed in the year accrued. The effect is to understate the probable future after-tax dollars in such an account. If, on average, capital gains are permitted to accrue for more than one year, there is the additional benefit of some *de facto* tax deferral.

- (2) In the case of common stocks, with a deferred annuity, all net accrued capital gains are ultimately taxed at ordinary income tax rates when withdrawn. In the case of an account that is not tax-deferred, long-term capital gains historically have usually been taxed at rates less than those on ordinary income. As of this writing, the maximum federal tax on long-term capital gains is 20%, while the maximum federal tax on ordinary income is 39.6%. Though Uncle Sam says we can defer the tax on our gains in a deferred annuity, he also says that, when we do pay the tax, we must pay at up to double the rate.
- (3) If we withdraw the funds from a deferred annuity before reaching age 59 1/2, in addition to our regular income tax, we also pay a 10% penalty tax.
- (4) If one accrues his capital gains in a tax-deferred annuity, his heirs forego the step-up in basis that would have been available, had unrealized capital gains accrued in a fully-taxable account. Since most people who have been in the stock market for a reasonable length of time usually die with enormous unrealized gains, this windfall of tax forgiveness is extremely valuable from an estate planning perspective. It is voluntarily cast away with the ownership of a deferred annuity.

THE CARDINAL SIN

Of all the inappropriate places one occasionally encounters a deferred annuity, surely the most blatant is in another tax-sheltered vehicle such as an IRA or a 401(k). There can be little justification for accepting all of the disadvantages of a deferred annuity under circumstances where its primary perceived benefit cannot even be enjoyed. Since one's IRA or 401(k) is already tax-sheltered, there are no incremental tax savings to be realized by funding such an account with a tax-deferred investment.

As an example, it is also not considered an enlightened investment practice to purchase tax-free municipal bonds in either a tax-deferred account such as a traditional IRA or 401(k) or in a tax-exempt account such as a Roth IRA or the portfolio of a charitable institution. There is no logic to accepting the lower rates of return associated with tax-free municipal bonds in accounts where the tax-advantage is redundant.

TO SELL OR TO HOLD A DEFERRED ANNUITY

One way of quantifying the decision of whether to sell or hold a deferred annuity is to relate the incremental return one would expect to earn outside the annuity to the incremental costs of surrendering it.

Deferred annuities commonly have "back-end" loads. Typically, such a load might amount to 7% initially and decrease by 1% until it reaches 0% at the end of the seventh year. If one has had the annuity for two years, and needs to wait another five years to eliminate the charge, he should recognize that, to make up the charge, he need earn only 1% more per year for five years. If we

expect to outperform the deferred annuity by 5% per year, as it is indicated in Table I above that we might, we have 4% per year to spare.

Similarly, if we are age 49 1/2 and so faced with a 10% penalty tax for early withdrawal, we really need increase our annual rate of return by 1% per year, at most, between ages 49 1/2 and 59 1/2 to make up the tax. If our expected incremental return is 5% per year, we have a sizable cushion. Remember, the penalty tax and other taxes are assessed upon only the accrued income, not upon the entire value of the annuity.

CONCLUSION

Though the deferral of taxes is tempting, it should be remembered that neither the deferral of taxes nor even the elimination of taxes is a logical investment goal in itself. Augmentation of one's after-tax return, however, is a legitimate investment objective; and the data is compelling that deferred annuities are rarely an optimal means toward that end.

The cover story for the February 9, 1998 issue of *Forbes Magazine* discusses deferred annuities in detail. The article is introduced on the cover with the following caption:

***Don't be a sucker!
Variable annuities are a lousy investment.***

and continues inside with,

The great annuity rip-off

Do you want proof positive that investors are irrational? Sales of variable annuities went up 16% last year, to \$85 billion.

A variable annuity is a mutual fund-type account wrapped in a thin veneer of insurance that renders the investment earnings tax-deferred. The tax deferral is just about the only good thing you can say about these investment products. Almost everything else about them is bad: the high – sometimes outlandishly high – costs, the lack of liquidity, the fact that the annuity converts low-taxed capital gains into high-taxed ordinary income. That tax deferral comes at a very high price.

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Any prospective customer who takes the time to understand annuities runs away screaming. A recent report by consulting firm Cerulli Associates puts the matter as delicately as it can: "Information about variable annuity purchases reveals that they do not appear to be based on educated decisions."

This article, by Carolyn T. Geer, can be found in its entirety on the internet in the *Forbes Magazine* archives at www.forbes.com.

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