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Variable Annuities:

Don't Stuff Your Investment Portfolio With A Lump of Coal[1]

Variable Annuities are sold more aggressively than fake Gucci handbags on the streets of New York City. Thanks in part to sales commissions of about 5%, sales of variable annuities have soared over the past decade.

But popularity is no indicator of practicality. The truth is, annuities only make sense for a tiny fraction of the population.

The Basics

First, a primer. A variable annuity is basically a tax-deferred investment vehicle that comes with an insurance contract, usually designed to protect you from a loss in capital. Thanks to the insurance wrapper, earnings inside the annuity grow tax-deferred, and the account isn't subject to annual contribution limits like those on other tax-favored vehicles like IRAs and 401(k)s. Typically you can choose from a menu of mutual funds, which in the variable annuity world are known as "sub accounts".

Variable annuities can be *immediate or deferred*. With a deferred annuity the account grows until you decide it's time to make withdrawals. When that time comes (which should be after age 59 1/2, or you owe an early withdrawal penalty) you can either annuitize your payments (which will provide regular payments over a set amount of time) or you can withdraw money as you see fit.

Fees, Fees and More Fees

Variable annuities are notorious for the fees they charge. Indeed, the average annual expense on variable annuity sub accounts currently stands at 2.08% of assets, according to Morningstar, an independent analytical firm. This figure includes fund expenses plus insurance expenses. The average mutual fund, on the other hand, charges just 1.38%. Unfortunately, variable annuity fees don't stop there. Many variable annuities also have loads on their sub accounts, surrender charges for selling within, say, seven years and an annual contract charge of about $37.

What Death Benefit?

The death benefit basically guarantees that your account will hold a certain value should you die before the annuity payments begin. With basic accounts, this typically means that your beneficiary will at least receive the total amount invested, even if the account has lost money. For an added fee, this figure can be periodically "stepped-up" or earn a small amount of interest. If you opt not to annuitize, the death benefit typically expires at a certain age, often around 75 years old. Given the fact that stocks have returned an average of 12% annually (assuming dividends are reinvested) from 1926 to 2004, according to the Center for Research in Security Prices, over the long haul you need this insurance about as much as a duck needs a paddle to swim.

Sure, investors who bought annuities and then died within the next two months probably got their money's worth. But currently only three out of every 1,000 variable annuities are surrendered due to death or disabilities, according

CFP Certified Financial Planner™

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to Limra International, an insurance-industry research group.

The price of this questionable feature:
an annual 1.03%, according to Morningstar.

Surrender Fees
Another problem with most variable annuities is that your money is often locked up for several years - typically five to seven[2]. Trying to withdraw funds during this time will result in huge fines. These fees typically decrease as the years tick by. For example, you might be charged a 7% surrender fee for a withdrawal during your first year of ownership. After seven years, however, that could be just 1%. The average fee is a steep 6.3%, according to Morningstar.

Early Withdrawal Penalty
As with most retirement accounts, if you withdraw funds before age 59 1/2, you'll be hit with a 10% early withdrawal tax penalty.

The Taxes
Gains in variable annuities are taxed at ordinary income tax rates, which go as high as 40% combined state and Federal. For most investors, that's a whole lot higher than the maximum 15% rate (about 18% combined State and Fed) they now pay on their long-term mutual fund gains and dividend income. And that tax difference can easily eat up the advantage of an annuity's tax-free compounding. You're generally going to have to wait 15 to 20 years before a deferred annuity becomes more tax efficient than a mutual fund.

World's Lousiest Estate-Planning Vehicle
There's no getting around the income tax due on annuities. In fact, if you die with money remaining in your annuity, your beneficiary will inherit all the taxes that you have deferred. Compare this to a mutual fund, whose basis is stepped-up at death. In that case, your beneficiary would owe no taxes on the gains. Both types of accounts - annuities and mutual funds - are liable for federal estate taxes on anything over the federal estate tax exemption ($2 million for 2006-2008).

Switch to a Low-Fee Variable Annuity
Now, if you've read all this and still want to buy an annuity, do yourself a favor and call us. We can set you up with a no load annuity with low annual costs and good investment options. Investors who already own run-of-the-mill high-priced annuities should consider a tax-free transfer, called a 1035 exchange, to a better quality, low-fee annuity.

The New, Higher Kiddie Tax

Government Pays for Waste by Going After College Funds:

In what has to be an all time low, even for politicians, Congress passed and the President signed into law a provision that now forces parents to pay higher taxes on funds accumulated in Uniform Minors Trust accounts, a frequently used source of funding for college. I have many clients who established UTMA's, as they are abbreviated, with the idea of earmarking funds for the day when Jr. reaches college age. Most of these accounts were established prior to the advent of better college savings vehicles such as Coverdale Education Savings Accounts and Qualified Tuition Plans (529 Plans).

"Kiddie tax" refers to the tax that is owed on unearned income (like interest and dividends) of a minor child. Currently, if a child is under age 14, the first $850 is tax exempt, the next $850 is taxed at the child's rate, and anything above $1,700 is taxed at the parents' rate. Under the old law, once children were 14 and older, they paid income tax at their own lower rates regardless of the amount earned by the UTMA. So, in the few years prior to college, gifts made to children were an advantageous way to build college funds with low taxation.

The new tax law pushes up the age to 18. So net unearned income above $1,700 will stay taxable at the parents' rate until the child is 18.
This will affect a lot of you who are saving for your children's college education. (But keep in mind that it affects you only if your child's portfolio is kicking off more than $1,700 in income per year.) Typically, you shift stock types of investments to fixed income the closer the child gets to starting college. You do that so your college nest egg is more secure. But fixed-income investments will generate more income that will now be taxed at a higher rate. So mid stream, the Feds have changed the rules of the game, scrounging for pennies in the piggy banks of our children.

If you are caught in this trap, give me a jingle, I may be able to help you re-orient your UTMA portfolio to take advantage of tax favored opportunities in low volatility/high dividend investments like REIT's or MLP's. Also, you may be able to transfer funds to a 529 Plan or ESA.

Saving Money by Using the Internet

I'm a Financial Advisor, not a car mechanic (well, I took a summer school course on car repair in 1965 when I turned 16 - does that count?). Anyway, I took my van in for a simple oil change and tire rotation the other day. I knew the service manager would call back recommending new tires - he always does, and they are always running a special on tires.
After I rejected his tire suggestion, he also mentioned that the mechanic who had looked at my van was recommending a "transmission flush". What? I thought - never heard of it, certainly not in my auto shop summer school class back in 1965. I asked him to tell me the why and how, and while he was talking I went onto the computer and Googled "Transmission Flush". This led me to a web site, http://autotechrepair.suite101.com/article.cfm/040206 that strongly argued against the procedure. In fact the article ended with the words "If you do get a flush, I recommend you do it when you can afford to replace the engine or transmission."

Fortunately I was able to scan the article while the service manager was giving his pitch. I politely declined his offer, and at the same time recalled that my wife complained about some residual issues the last time we took her car in for service at that same station.

Anyway, the article that may have rescued me is part of an interesting web site called suite101.com. The articles are written by a variety of self styled experts on a wide range of topics. No guarantee that they will be accurate, but my sense, from the experience described above is that they can offer a useful perspective.

Meet Sharon Ryan

Most clients have spoken to Sharon, our receptionist, but don't know that she is also a legal secretary with over 30 years experience. A native of Milwaukee, Sharon has lived much of her life on a boat in Dana Point harbor. She is pictured here with her best friend "Schatzy"

Class and Workshop Schedule

Title	Location	Date/Time	To register call or visit...
Financial Independence for Women	Saddleback Community College	3 Thurs. evenings Feb 22 - March 8, 2007 6:30 -9:00 PM	949 582 4646 www.saddleback-ce.com

Footnotes

1. This article is adopted from one that appears at SmartMoney.com
2. Recently I encountered a prospective client who is tied up for 10 years with early withdrawal penalties!!