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Intelligent Money

Louis Kokernak CFP, CFA

Haven Financial Advisors
7000 N. Mo-Pac Expy.
2nd Floor
Austin, TX 78731
voice 512 514 6250
fax 800 888 5480
louis@havenfinancial.com

Special Notes of Interest:

- In Texas, home equity lenders generally do not charge points or closing costs. While home equity loan rates are higher than cash out refinancing, they are often a better option for short term borrowers.
- There are no payroll deductions on distributions taken from your pension plan. Thus your effective tax rate is lower.

Current thinking from Haven Financial Advisors

Variable Annuities

It is quite common for individuals to come to me with one or more variable annuities in their existing investment portfolio. Annuities offer some real benefits but are often sold for the wrong reasons. As a result, the entire product class suffers. The vast majority of variable annuities are sold with sales loads that directly compensate the agent up front. Moreover, ongoing expenses of annuity account management are half again as large as those of conventional mutual funds. For many, the costs outweigh the potential benefits.

The good news is that variable annuity owner can always look for a less expensive carrier that more fairly prices its benefits. As we'll see, there are significant cost savings to be had with a little comparison shopping. Most policy owners can exchange their expensive annuity contracts for products that offer every bit the investment flexibility and protection for a fraction of the cost. This article will survey the variable annuity market and offer some practical advice on the purchase and maintenance of annuity contracts.

A variable annuity is a private contract between the insured and an insurance company under which the insurer agrees to make periodic payments to the insured, beginning either immediately or at some future date. The variable annuity contract is purchased by making either a single purchase payment or a series of purchase payments. Each annuity contract consists of several investment options or "subaccounts" that vary from carrier to carrier. The policy holder can transfer assets from subaccount to subaccount without generating a taxable event. One can rebalance an investment portfolio without concern for taxes as retirement approaches. Apart from the promise of guaranteed payments late in life, variable annuities are characterized by three major features: tax-deferred accumulation of value, guaranteed death benefits, and some measure of asset protection.

Sales agents often tout the tax deferred accumulation features of a variable annuity. Yet it is interesting to note that half of all annuities are sold to confused 401(k) and individual retirement account savers, who pay extra for a tax-deferred investment in an account that already postpones taxes. Annuity contracts are sometimes described as "private pensions" in that the investor pays no taxes on the gains under the contract as long as no distributions are withdrawn. Unlike real pensions, however, no immediate tax deduction is allowed for contributions to a variable annuity. Distributed gains from variable annuity contracts are taxed at ordinary income tax rates rather than the lower long term capital gains tax rates available to sellers of taxable investments.

On balance, the tax treatment of variable annuities is inferior to that of a well crafted passive asset management program. ***Rule of Thumb***: most investors should at least exhaust the contribution limitations of their qualified retirement plans and IRAs before relying on the questionable tax shelter properties of a variable annuity.

The guaranteed death benefit typically assures that the policy's beneficiary receives the greater of (i) all the money in the account, or (ii) some guaranteed minimum (such as all

Variable annuities (continued)

purchase payments minus prior withdrawals). In other words, there is a floor to the payout that is protected against market reversals. Many annuities now have "step up" provisions that periodically ratchet the guaranteed payout every few years. As a practical matter, the fair market value of this death benefit floor is minimal and should not drive the purchase of annuity contracts. The annuity creates additional problems at the insured's death. Unlike assets kept in taxable accounts, the beneficiaries of variable annuity products do not enjoy a step-up in the taxable basis of the investments held inside the contract. Investment gains to an annuity contract are taxed as ordinary income.

"The key here is that any asset protection strategy must begin in good faith prior to a lawsuit. Otherwise, it will be seen as a fraudulent transaction and annuity protections will be negated."

Asset protection can be an important benefit to a variable annuity contract. The protections afforded vary from state to state. While federal law confers only minimum protection for investments in variable annuities, the laws in six states--Colorado, Florida, Michigan, New Mexico, Oklahoma, and Texas--assign strong protection. Texas law stipulates that the proceeds of annuity contracts "are fully exempt from creditors and from all demands in any bankruptcy and from execution, attachment, garnishment, or other legal process unless a statutory exemption, such as fraud, is applicable." The key here is that any asset protection strategy must begin in good faith prior to a lawsuit. Otherwise, it will be seen as a fraudulent transaction and annuity protections will be negated. Policy owners should also be careful to avoid naming their estates as the beneficiary of their variable annuities. In that event, the money will become available to creditors after the owner's death. That having been said, individuals in high risk employment such as physicians and contractors might find the variable annuity to be an effective piece of insulation against predators.

Annual costs to variable annuity contracts vary considerably around an average of 2.11% of assets, according to Morningstar Inc. The mortality and administrative charges they heap upon their customers tend to be well above competitive levels. Many products even have trailing "surrender" charges that penalize policyholders attempting to exchange their annuities prior to some minimum holding period. The good news is that inexpensive alternatives exist to the annuities that you may already have in hand. With a minimum of paperwork, you can move into a less costly product that has all the important features of your current policy.

Most annuity contracts outstanding today are still accumulating value and are not paying regular distributions. As such, they may be freely exchanged for similar contracts. Retain this flexibility in your policy until you find the right carrier. I recommend low cost annuity programs run by the Vanguard Group and TIAA-CREF. Both offer flexible investment options with mortality and expense costs of less than 0.40% annually. Once you've decided on a carrier, annuities can effectively serve as the repository for investments that tend to be less tax efficient such as bonds and REITs.

Variable annuities can play a constructive role in a retirement plan. While most are costly, they can be exchanged for more reasonable alternatives and invested to maximize the benefits of the tax and asset protection shelters they offer. The market is getting more competitive and is worth revisiting periodically.

First Aid for your 401(k)

Many people that I've spoken with over the last several months no longer look at their quarterly 401(k) statement. They're afraid to. There is nevertheless much to be accomplished by making a dispassionate reevaluation of your retirement strategy.

What are 401(k) plans offering these days? Far from offering too few investment options, plan sponsors offer too many. According to the most recent survey conducted by the Profit Sharing Council of America, the average participant can choose from 12 investment alternatives. The number of companies offering at least 10 options has increased to 61.5% from 38.8% in the last two survey years!

Most of these offerings are redundant from the standpoint of investment style. Yet employees dutifully sprinkle their portfolios with helpings from all their investment options in the belief that they will be diversified. That is generally not the case, however. Investing in all the available funds equally tends to make a portfolio bottom-heavy in small or micro cap stocks.

It is better to keep things simple. Generally, there are no more than two or three useful investment options in every 401(k) plan . Indexed equity and fixed-income products should rank high on any employee's selection list.

For most employees, their employer matches some fraction of elective deferrals. For this reason alone, it is worthwhile to invest in a 401(k) – even one without ideal investment alternatives. However, additional analysis is required to determine the usefulness of additional unmatched contributions.

Until recently the administrative costs of 401(k) plans were assumed by the employer. Now, however, expenses are being shifted to plan participants. While these plan administration expenses are generally less than 0.5% of assets, they are increasing. Management fees typically supplement these costs and can vary by investment option.

It is important to assess whether these costs negate the value of salary deferrals beyond levels matched by the sponsor. To put things in perspective, a 401(k) with annual maintenance and management fees of 1% would deduct nearly 25% of the expected returns of a government bond fund in today's environment. Think of those fees as a "tax".

To the extent that the limits within your tax-deferred accounts fall short of your ability to save, it makes sense to prioritize the asset classes placed inside qualified plans and IRAs. Why waste the tax shelter of a 401(k) on an asset that generates little tax liability anyway.

Passive equity investments are an example of a tax efficient asset that would function well in a taxable account. Most of their returns are in the form of capital gains that are seldom realized in an indexed portfolio. On the other hand, government bonds pay their gains primarily as ordinary income and are best placed inside a 401(k).

The asset allocation of a 401(k) account is very important. For many, the 401(k) is their largest repository of investable assets. The recent decrease in account value is no reason to skirt the issue. To the contrary, the high volatility of equity assets over the past year makes it imperative to rebalance your portfolio. Any target allocation put in place some time ago has no doubt been altered substantially due to market action. Retirement shouldn't be left to chance.

"Government bonds that pay their gains primarily as ordinary income are best placed inside a qualified plan or IRA".