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Credit-report mistakes can cost you
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Safe or sorry? Some truths about annuities

What you need is probably not what your agent is pushing.

Dr. Jekyll and Mr. Hyde are alive and well in retirement planning. They're embodied in two versions of an annuity, an investment meant to provide security to retirees through regular monthly payments.

The not-so-nice Mr. Hyde version—the variable annuity—has long had a tarnished reputation among investment experts because of high associated fees. It's a bad deal for most consumers (see the box on page 4). But insurance agents, who earn up to a 6 percent commission, push the variable annuity aggressively. Of the roughly $2 trillion worth of various annuity products in retirement portfolios in the U.S., $1.5 trillion are the variable kind.

The more benign Dr. Jekyll version—the fixed immediate annuity—isn't sold as aggressively. But it's worth considering in some situations. In this report we discuss when it makes sense to use one in a diversified investment plan.

HOW ANNUITIES WORK

For most Americans, Social Security is the only guarantee of a monthly check in retirement. But for someone with average earnings, the benefit covers only 40 percent of

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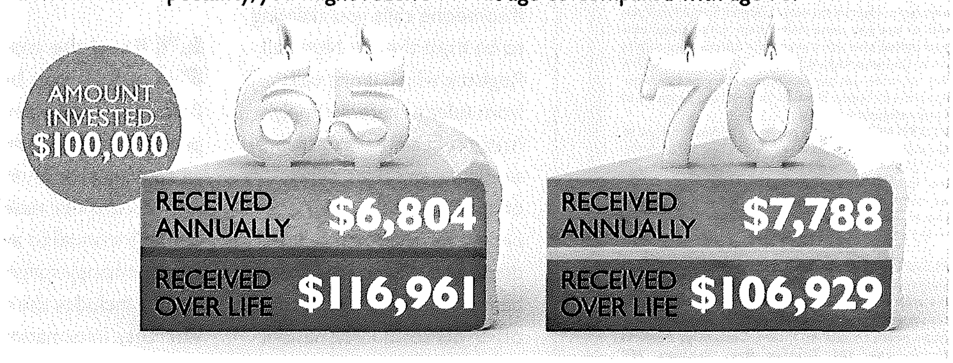
When to buy a fixed immediate annuity

Deciding at what age to buy an annuity is a bit of an art. The longer you wait, the more you get per year; insurers pay you more per month for a shorter expected life span. But assuming a normal life expectancy, you might receive more in total by taking payments earlier. Here's how much a New Jersey man with normal life expectancy could expect to receive from a $100,000 fixed immediate annuity purchased at age 65 compared with age 70.



Source: ImmediateAnnuities.com; Social Security Actuarial Life Table 2007. Calculations assume the 65-year-old man lives 17.19 years longer and the 70-year-old man lives 13.73 years longer.

Annuities

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pre-retirement income, the Social Security Administration says. And many people doubt its long-term viability.

In response to retirement fears, insurers devised annuities: insurance that you won't outlive your money. You pay a premium over time or in a lump sum. The company takes a cut, invests your money, and pays you back a monthly sum over a fixed period or your lifetime, even if you live to be 108. Several factors, including life expectancy, determine the payout.

Social Security itself works like an annuity. Your years of payroll taxes contribute to a given sum that you begin to access at retirement. In fact, you can essentially "buy" an annuity simply by postponing when you claim Social Security. If you're now age 66, currently considered "full retirement age," you can raise your benefit by 8 percent for each year you wait to claim. If you wait until 70, the maximum age to claim, your benefit will be 32 percent more than what you'd get by claiming now.

COMPARE ANNUITY TYPES

Following are more details about two versions of this investment:

▶ **A fixed immediate annuity.** You pay a sum up front—at least $10,000—and get fixed monthly payouts right away. Fees are built in to the quoted price. Unlike regular insurance, your investment is lost if you buy it and die a week later. Adding a survivor benefit lowers the monthly payout.

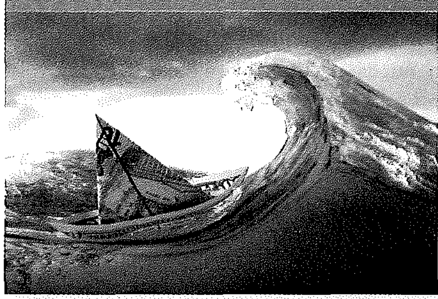
▶ **A variable annuity.** You invest at intervals in an assortment of mutual funds. You can opt for a minimum monthly payment that increases if your investments do well. It's often sold with costly riders and features that can top 4 percent annually (see the box below). "Variable annuities mostly benefit the sales broker rather than the purchaser," says Rand Spero, president of Street Smart Financial, a fee-only financial planning firm in Lexington, Mass.

Annuity holders should also watch out for scams, especially those involving "churning," or cashing in policies for new commission-generating investments. In November 2012, for instance, Marshall Virden, a former insurance agent, was sentenced to two years in prison in Oklahoma for persuading seniors to cash in annuities in exchange for precious metals like gold. "This heartbreaking crime cost several Oklahomans their life savings," John Doak, the state's insurance commissioner, said in a statement.

ADD SECURITY FOR YOUR FUTURE

Many financial advisers we consulted said that portfolios of stock and bond mutual funds could achieve the same or better goal as annuities: relatively consistent dividend and interest income that meets or exceeds inflation. So why buy a fixed immediate annuity?

Variable annuities aren't for the faint of heart



Variable annuities are best for people who have a very high income; work at an employer that doesn't offer a 401(k); or are self-employed with no retirement account but lots of years until retirement.

On the surface, variable annuities have their attractions. The money in them grows tax-deferred. Unlike individual retirement accounts, annual contributions aren't limited or subject to required minimum distributions. Funding an annuity with tax-inefficient, high-yield bonds or real-estate investment trusts (REITs) might make sense, but only after you've fully funded your tax-deferred retirement accounts for the year.

Even then, think hard about this insurance product, which has wallet-sapping fees. To make a variable annuity worthwhile often requires adding riders, such as a death benefit to ensure that your heirs get the annuity's principal. Each feature typically adds 0.5 to 2 percent to your annual expenses; you could easily spend 4 percent a year. In contrast, average large-cap mutual-fund annual expenses are 1.3 percent of assets, says the investment research firm Morningstar.

Prudential Premier Retirement B Series shares is an example of a high-fee variable annuity. Like every variable annuity, Prudential lets you purchase from a variety of mutual funds. A typical option—say, the T. Rowe Price Asset Allocation Fund—has annual expenses of 0.93 percent of assets.

But you could pay for features that would be unnecessary if you invested directly in the fund. For example, you must pay a 1.45 percent "mortality and expense risk" fee, which compensates the insurer if you live longer than expected.

A "guaranteed living withdrawal benefit" rider, which grants you a minimum income regardless of the market's performance—plus a death benefit that leaves money to your heirs—costs another 1.5 percent per year. "That is one feature that may be worth buying," says Wade Pfau, a professor of retirement income at The American College in Bryn Mawr, Pa., and an expert in annuities.

And if you withdraw some or all of your money within the first seven years of the annuity, you'll pay a fee of up to 7 percent of the withdrawal.

Most variable annuities are complex and hard to compare. The least objectionable are from companies with numerous low-cost mutual funds, such as Fidelity, Schwab, TD Ameritrade, and Vanguard. Jefferson National offers variable annuities through financial advisers for a flat $20-per-month fee (on top of mutual-fund expenses). It offers nearly 400 investment choices.

Ask about the "free look" period, during which you can change your mind before the contract becomes effective.

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