Financial Planning

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Fee Factor

When your clients buy annuities, do you really know what they're paying for? By Patrick Ferrer

IN TODAY'S REGULATORY-SKITTISH, ADVOCACY-SENSITIVE environment, "fee transparency" is definitely the mantra for all kinds of financial products. Unfortunately, it may still be slow in coming to the world of variable annuities.

That's not to say that real progress has not been made in streamlining product designs and fee structures so that annuities can offer consumers a better value—and advisers a better planning tool. But until that's more widespread, here's a primer on how to peel away the layers of an annuity's fees so you can weigh the benefits of what your clients are getting—against the cost of what they're paying.

In general, variable annuity owners are subject to two levels of fees. There are fees charged for management and other services at the underlying fund level. Then there are insurance-related fees from the issuing insurance company.

There are also different types of fees within these levels. Most of an annuity's fees are asset-based charges, equaling a certain percentage of the annuity's account value. So the more your clients invest and the more their account value grows, the more they pay in fees. Other fees are driven by a transaction or time period, like annual service charges or additional trading fees.

EVALUATING INVESTMENT FEES

First, let's take a closer look at a variable annuities' investment-related charges. Since variable annuities have underlying funds, they all assess annual asset-based fees on the balance invested in each fund. These fees vary by subaccount, averaging from 0.623% for money market funds to 2.3% for bear market domestic stock funds, according to the National Association of Variable Annuities' (NAVA's) *2005 Annuity Fact Book*. These investment fees cover the cost of professional management oversight, including fundamental research, ongoing monitoring and allocation rebalancing, and may also include 12b-1 fees (also known as distribution fees), which may pay for marketing and distribution expenses such as compensating sales professionals.

Here's something to watch for, though. How many of the underlying funds are sponsored by the annuity company? And, how much of your client's assets are tied up in these particular funds? Proprietary funds can be another way some variable annuity companies generate more revenue for themselves.

Also check the rules for trading among the annuity's funds. Some companies restrict the number of free trades in a year, assessing a transaction-based fee (for example, $25 per trade) for any trades above the cutoff. This may be an issue if your clients expect you to actively manage the assets in their variable annuity.

PEELING BACK INSURANCE CHARGES

Most variable annuities get criticized for the insurance-related fees that drive costs up and performance down. Here's what to look for in this level of fees:

Mortality and expense (M&E) charges. Most, but not all annuity issuers assess what's referred to as M&E charges. According to Morningstar data through the second quarter of 2005, this asset-based charge for all variable annuities averaged 1.211%. For most annuities, this fee covers the insurance guarantees the issuer provides: the basic death benefit guarantee, the promise that annual insurance charges won't increase and the ability to choose a guaranteed lifetime payout option down the road at the rates specified in the contract.

Remember, this is an asset-based fee. So the greater the annuity's value, the higher the costs of these guarantees. For a $100,000 annuity, the owner may pay around $1,200 in M&E fees; for a $500,000 annuity, the owner pays around $6,000. Considering that the value of an annuity's tax-deferral benefit has declined in the last few years (thanks to exchange-traded funds and tax reform), high M&E fees can make a high-balance variable annuity a less attractive deal.

Death benefit riders. All variable annuities have basic death benefit protection built in—a guaranteed return of the current account value or some portion of the initial premium if the annuity owner dies before payments begin. Now, though, NAVA reports that 93% of all annuities offer some enhanced death benefit by purchasing a death benefit "rider."

Say your client adds an enhanced death benefit rider for an extra 40 basis points a year. On a $500,000 annuity, that would cost him or her an extra $2,000 a year…on top of the M&E fee. Now both of those annual fees are chipping away at returns earned by the underlying funds. Some clients may like this extra death protection, but at what cost? If they're insurable, a term life policy may be a more cost-efficient alternative.

Living benefit riders. Many annuities also offer options that guarantee an enriched income payment at some time in the future. However, just as with enhanced death benefits, annuity owners pay for this privilege. Annual fees for these riders are also asset-based, and they typically range from 30 to 75 basis points a year per guaranteed benefit added.

Here's another thing many variable annuity purchasers haven't considered. While annuities grow tax-deferred, annuity income benefits are taxable. So that enhanced benefit has a bigger tax bite for its recipients. For clients looking to lock in additional future income, tax-free bonds may be a better alternative. The client may get more tax-advantaged income later, without the drag of all the variable annuity's annual fees.

Annual policy fees. While the policy fee may be a nominal amount (say, $25 a year), it does add to the costs.

Surrender charges. If your client already owns a variable annuity, commissions have long since been paid. And, true, commissions didn't come out of the contract in the first place—the insurance company covered the commission. To pay itself back, however, the insurance company needs to keep that annuity on the books for a number of years. That's where surrender charges come in. If the annuity owner cancels the contract in the early years, some issuers assess surrender charges to defray commissions.

If you're advising a client about a variable annuity he or she already owns, check the contract to find out whether surrender charges apply and when they expire. If you're considering recommending a variable annuity, look for one that's free of surrender charges and commissions—they do exist. It will allow you to preserve your objective stance in pursuit of what's best for the client.

Itemized Bill

Here's what it might cost annually to own a $100,000 annuity. Notice how some of the possible investment- and insurance-related fees could drain this annuity's performance.

Annual Investment-Related Fees (all asset-based charges)

Hypothetical Annuity Subaccount	Amount Invested	Sample Expense Ratios	Sample Fees
S&P Index Fund	$25,000	0.30%	$75
Government Bond Fund	$25,000	0.60%	$150
Growth Fund	$25,000	1.00%	$250
International Fund	$25,000	1.25%	$313
TOTAL			$788

Annual Insurance-Related Fees (all asset-based charges)

Type of Charge	Asset-Based Charge	Sample Fees
Mortality and Expense Charge	1.211%*	$1,211
Administrative Expense	0.15%	$150
Death Benefit Rider	0.35%	$350
Living Benefit Rider	0.35%	$350
TOTAL		$2,061

Total Annual Costs for a Hypothetical $100,000 Annuity: $2,849

Total Annual Costs for a Hypothetical $500,000 Annuity: $14,245

**Based on the average annual annuity mortality and expense (M&E) charge as reported by Morningstar for the period ending Dec.30, 2004.*

Source: Jefferson National Life Insurance Co.

WHAT THE STATEMENT DOESN'T STATE

Here's another little-known fact: Fees are not explicitly reported on variable annuity statements. All the client sees is performance after fees have been deducted. So there's no annual reminder of what the customer is paying for, or what it's costing in terms of performance.

The best way to deconstruct the fees for a particular variable annuity is to read the prospectus. Then, talk to your client. First, does the annuity's long-term tax deferral match the client's financial objective? Second, do death benefit and living riders (if present) offer worthwhile guarantees—at a good value? And, finally, if a change is warranted, have surrender charges expired? The right variable annuity can still offer an attractive value for many clients, but only if it's not bogged down with excessive fees. **FP**

Patrick Ferrer, national sales director at JeffersonNational Life Insurance Co., helped develop Monument Advisor, a low-cost variable annuity. For more information, visit www.jeff-nat.com or call (866) 667-0564.

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Variable annuities are long-term investments to help you meet retirement and other long-range goals. Variable annuities are complex products, however, and are not suitable for everyone. They are not designed for meeting short-term goals because substantial taxes and insurance company charges may apply if you withdraw your money early. Withdrawal of tax-deferred accumulations may be subject to deferred sales charges and are subject to ordinary income tax. If owners who are less than age 59 1/2 make withdrawals, those withdrawals may incur a 10% IRS tax penalty. Neither Jefferson National nor its representatives are qualified to give tax advice.

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