Annuities in Your IRA – A Poor Choice

By Angela Thomson, CFP®

It's tax time, and you have started to think about contributions to your IRA, or you may have recently retired and need to roll your 401(k) or 403(b) into an IRA. You contacted an insurance person or a bank or a broker, and the "financial advisor" is recommending rolling into or establishing an annuity for your IRA investments. Stop right there. The last thing you want to do is put your retirement funds in an annuity. If you do it, you are creating a tax shelter inside a tax-deferred vehicle – which is unnecessary – and you are paying an incredible premium for this product!

There are limited applications for an annuity, limited investment opportunities, and large surrender charges associated with annuities for the first seven years that you hold the product.

Let's start with the investment opportunities. The best variable IRA annuities I have seen offer 20 different investment products within the annuity. Conversely, an IRA held outside of an annuity can be invested in your choices of thousands of mutual funds, stocks, bonds, money markets or even certificates of deposit. The IRA portfolio can be rebalanced at any time to adjust for market conditions, or to reduce risk exposure as you near retirement.

Now you need to start thinking of surrender charges associated with annuities. If you have decided one year after you have held the IRA annuity that you made a mistake and want out, you face anywhere from a 6% – 7% surrender charge. That's your money you have to give them for allowing you the opportunity to invest in their products. In contrast, if you decide you want out of a no-load mutual fund, the most you will incur in a trade charge cost ranging from $25 - $75.

An example of how costly these products are to hold can be illustrated as follows: You are leaving your company after 25 years of service. You have accumulated $300,000 in your company-sponsored retirement plan. You have made the decision to roll over this amount into an IRA. Joe Salesman has done a great job of only discussing his perceived positives of an investment in an IRA annuity.

After one year with this product, you are disappointed with the returns and have decided that maybe a more active approach to asset management is necessary. Your balance at the time of the transfer to a new custodian is $315,000. The early surrender charge for your account is 6%, so the total transfer amount is $296,100. You have now given back all your gains, plus paid out an additional $3,900. This is the part Joe Salesman never shared with you.

If that same investment was placed in a portfolio which contained a mix of stocks, bonds, and mutual funds, and you wanted to reallocate and reduce you exposure to some of the equities, the trades would equate to $25 - $75 per transaction. So if you sold four stock holdings, the cost would range from $100 - $300. Assuming the balanced portfolio was also valued at $315,000, your costs have dropped dramatically.

Another consideration is, if you have an advisor that actively manages your portfolio annual charges will run from 0.50% - 2.0% for portfolio management. The advisor will generally formulate an investment strategy based on your risk tolerance and time horizon and meet with you on a regular basis to review performance. Simply stated, you are paying for service. In this type of arrangement, trade costs are usually waived. In contrast, your annuity salesperson does not manage anything. He or she simply sets you up and go on their way, leaving you to suffer through whatever investment decisions were established from the onset.

Finally, I would like to address the issue of trailing commissions, also known as “trails”. Trails are annual payouts made to the commissioned person that sold you the variable annuity. The salesperson will continue to receive these trails for as long as you hold the IRA annuity. In some cases, once you have established the annuity you may not ever see the salesperson again (or if you’re lucky you might receive an occasional phone call). For as long as you hold this product, the salesperson that sold it to you, continues to profit from the transaction, for doing nothing. My belief has always been a fair day’s work for fair days’ pay; I fail to see how trails without follow-up service are fair.

To clarify how this practice is different from what you would expect in other industries, let's take the case of you going to the doctors because of some ailment. You go to the doctor’s office; you receive a diagnosis and perhaps a prescription. You come back for a follow-up visit a few weeks later, and pay the doctor for his services. One year later, you receive a bill from your doctor for that very same service. You call his office – Why did I receive this bill? Imagine if the answer was: Well, he/she cured you last year, and you have to pay for that cure as long as you are healthy. Would you pay that bill? This is what is happening to you with an annuity. You are not getting a bill, but the person that sold you the product is getting an annual payout that has to come from somewhere, and that somewhere is lower dollars being returned to the investor.

Finally, if you need to establish an IRA or roll over retirement funds, shop around. There are many qualified advisors who can provide advice you can count on. Read the information on NAPFA’s Web site about “How To Choose a Financial Planner.” Take time to do the research and make the right decision the first time.