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How Variable Annuities Help You Provide for Your Own Future

A GENERATION AGO, Americans seldom changed jobs and routinely retired with comfortable, reliable pensions. But those days have become distant memories.

Only 23 percent of working people now rely on a traditional benefit plan, according to the Employee Benefits Research Institute. And constant pressures on management to reign in fixed costs means even those programs are far from secure.

Fortunately for the 77 million baby boomers poised to retire over the next two decades, new financial products are coming on line to help people provide for their own futures. Leading the way, thanks to a spate of innovation in recent years, are variable annuities.

An annuity is an insurance contract that provides for liquidation of assets over a specified period of time, or for as long as a person may live. Under the arrangement, a person shifts to an insurance company the risk of living longer than his or her assets. A fixed annuity locks in a specific payout plan, which binds both parties whether markets go up or down. A variable annuity builds in a possibility for the value of underlying assets, and in some cases payment size(s) to vary depending on market performance.

>>Now the variable annuities marketplace counts more than 1,000 distinct products– a 400 percent increase over the past decade – including some for cost-sensitive investors as well as those who appreciate firm guarantees.
National Association for Variable Annuities (NAVA)

Owners of variable annuities have a versatile vehicle in their portfolio. Committed assets typically get invested on a tax-deferred basis, usually in mutual funds, where they have a chance to grow with financial markets. Even after regular payments have begun, underlying assets may in many cases keep growing. Upon the owner's death, beneficiaries receive payouts akin to a life insurance settlement.

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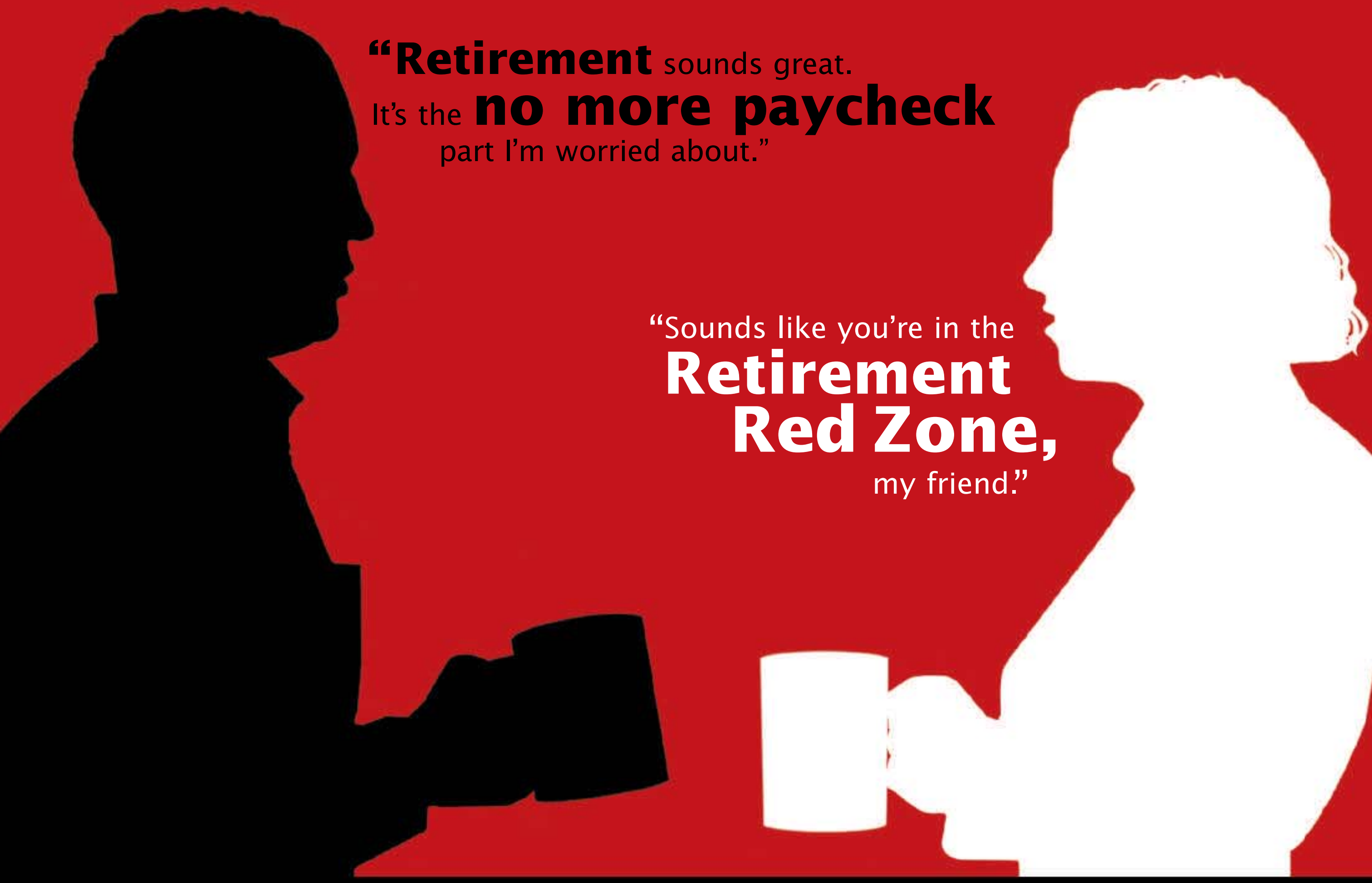
In approaching retirement, investors face a whole new set of challenges as they shift to a portfolio that's often heavy with fixed-income instruments. For starters, they need to minimize risk while still staying ahead of inflation. But many also need to keep growing assets in order to provide for the unpredictable.

"Sometimes it's hard for people to know five, six or even 10 years in advance what they're really going to need in retirement," says Patricia Colby, principal for annuity and insurance services at Vanguard. Such uncertainty, she says, heightens the importance of keeping options open – and finding investment vehicles that take full advantage of bull markets.



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To meet these needs and also satisfy a thirst for reliable income, insurers are offering variable annuities with "living benefits" riders that are getting a warm welcome in the marketplace. Investors opted for them in 89 percent of new variable annuities sales from the first half of 2006, according to NAVA data.

Sales patterns from recent years suggest one of the hottest items in this "living benefits" category is the Guaranteed Minimum Withdrawal Benefit (GMWB), and it's easy to see why retirees and boomers like it so much. Even if markets tank and the value of invested assets plummets, this rider promises payouts calculated at high points in the portfolio's historic performance. What's more, through benefits known as "GMWB for Life," underwriters make sure payments of a fixed size continue for as long as an individual or couple may live.

Bottom line: investors who opt for these benefits can stay in the potentially lucrative stock market without worrying that income streams in their twilight years could vanish overnight.

"Living benefit guarantees have entirely changed the nature of the variable annuity solution for the investor," says David Odenath, president of Prudential Annuities. "They allow investors to enjoy much of the upside of the market, but have protection against the downside of the market."

An impending wave of boomer retirements has helped make variable annuities the fastest-growing sector of insurance products. The industry counted $1.3 trillion in assets in the first quarter of 2006, up 14.2 percent from a year earlier and 61.2 percent from 2002. As the industry grows, so also has the pace of mergers and acquisitions as companies position themselves to be leaders. The number of firms selling variable annuities dropped from 61 to 45 between 1996 and 2005, according to NAVA.

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Steve Lovell, Financial Planner

To stay ahead in this hot industry, companies are tailoring innovations to curb risk and boost returns simultaneously. In November 2006, for instance, Prudential expanded options available through its Lifetime Five series, which had already guaranteed annuitants a cash flow of five percent of invested assets for life. With its unique Highest Daily Lifetime Five product, Prudential now records the value of underlying assets every day the market is open, thus enabling investors to lock in payments of five percent of asset values at their absolute historic peak.

In exchange for offering upside market potential while mitigating an investor's risk, issuers of variable annuities charge fees. Costs associated with managing assets in mutual fund "sub-accounts" tend to be slightly lower than investors would pay if they bought into the same funds directly, according to Michael DeGeorge, vice president and general counsel at NAVA. Beyond those charges, issuers collect a mortality and expense (M&E) fee; the industry's average M&E charge is 1.2% of assets per annum. Additional fees sometimes apply for specific riders and death benefits.

Finding Value in Annuities

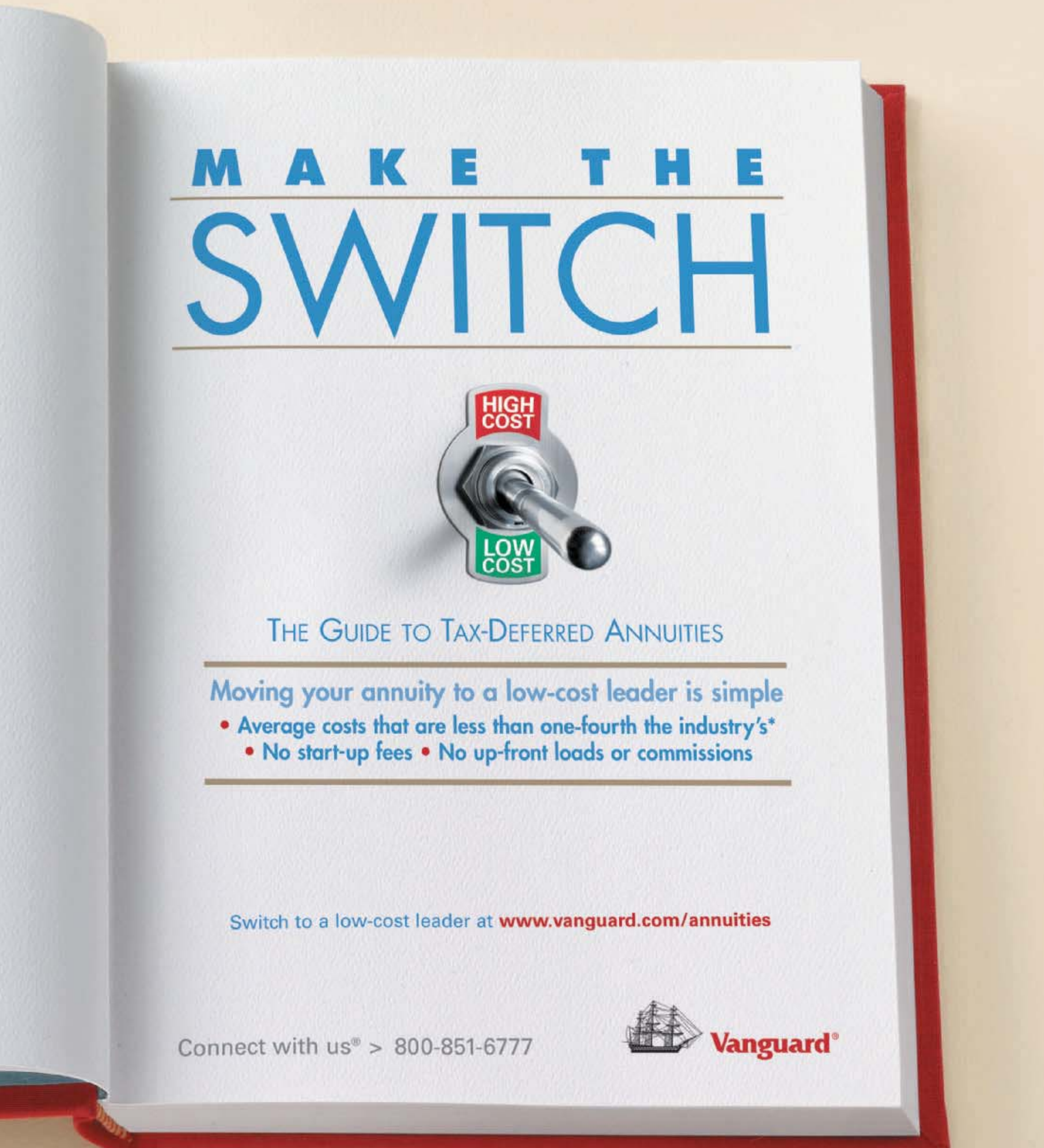
In the past, some investors have shied away from variable annuities in order to avoid the fees and retain more flexibility. But now investors have more choices and flexibility than ever before, and some financial planners believe today's revamped products have become a bargain.

"Annuities are under-priced, not over-priced," says Stephen Lovell, a financial planner in Walnut Creek, Calif. "Those expenses are buying you two really important features: a death benefit [and] a lifetime income benefit. And if that didn't have any value, then why is it that corporations are taking it away from employees?"

Even so, price-sensitive investors are always inclined to sniff out low-cost options. For them, mutual fund giant Vanguard has teamed up with two insurers to cut out middlemen and sell variable annuities directly to customers. Investors get access to low-cost Vanguard funds for their underlying assets, and they forego some of the living benefit guarantees that drive up fees elsewhere.

Result: a variable annuity whose expense ratio of .57% puts it well below the 2.34% average for the industry.

As the variable annuity industry evolves, investors are clearly finding a wide range of newly tailored products to suit their own evolving needs and budgets. And that's good, because in an age fraught with retirement uncertainties, they just might want a few new options. ■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