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## **THE WALL STREET JOURNAL**

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ANNUITIES

# Locking in Future Income

*Variable annuities can shield your nest egg from stock-market losses. But make sure to understand what is guaranteed—and what that promise will cost you.*

By [LESLIE SCISM](#)

These days, pitches for variable annuities are coming not just from insurance companies and financial advisers—they're the stuff of cocktail-party chatter from your neighbor. That's usually a sign to take a step back and ask some serious questions before you plunge into an investment just to keep up.

So, here's what you need to know about variable annuities.

### *The Basics*

**QUESTION:** *Why all the fuss about these products?*

**ANSWER:** Simple: Most variable annuities offer some guaranteed minimum payout. Many people appreciated the protection when stocks slid last year.

**QUESTION:** *Guarantees sound great these days. Why doesn't everyone buy them?*

**ANSWER:** The big knock on the products is that they carry very steep fees. And there's another drawback: Under most contracts, you can't get your guaranteed amount in a lump sum. It is paid out as a stream of income over your lifetime.

In other words, these guarantees don't help people who may need access to the money all at once. But they can be valuable to those who don't have old-fashioned pension plans to draw on, particularly single women expected to live long lives.

Another caveat: If a neighbor boasts of a generous guarantee, it probably isn't for sale these days. The juiciest ones have been pulled from the market, after regulators last year required insurers to boost reserves and capital to show they can make good on their promises.

### *Looking at the Details*

**QUESTION:** *So, how do the products work?*

**ANSWER:** There are many versions, but most are set up like this. You invest in tax-advantaged funds, akin to a 401(k). From there, you have to keep track of two dollar figures. One is the account balance for your underlying funds—in other words, the amount you invest

and any gains you accrue. The other is the guaranteed minimum benefit base, to be used to calculate lifetime payments.

**QUESTION:** *How does an insurer calculate my benefit base?*

**ANSWER:** Under many contracts, the benefit base is "reset" annually to incorporate investment gains, if any, from the underlying funds. If you gain *less* than the guaranteed minimum in the specified period, your benefit base gets boosted by the guaranteed amount instead. Products from insurers including MetLife Inc., Prudential PLC's Jackson National Life Insurance Co. and Prudential Financial Inc. increase the benefit base between 5% and 6% a year, for at least 10 years or until your first withdrawal. (A year ago, some contracts promised minimum 10% annual increases—but good luck finding those now.)

**QUESTION:** *How do I get paid?*

**ANSWER:** In general, you have two options. One, you can pull your money out of the underlying funds as a lump sum (avoiding tax penalties if you are at least 59½ years old). Of course, the guarantee doesn't apply if you do that—so you would usually go this route only if your funds were performing strongly.

Second, you can choose to draw on the guaranteed amount from your benefit base. But you can't get this as a lump sum—you pull it out under terms specified by the contract. Typically, those 65 or older receive lifetime annual payments of 5% of the benefit base.

For all that, you can easily pay 3.5% annually in fees, pegged partly to your funds and partly to the guaranteed amount.

*What About Timing?*

**QUESTION:** *Is now a good time to buy, to protect gains from the market rally?*

**ANSWER:** These products are far too complex for yes-no answers.

If, for instance, the market falls sharply just after you buy and your underlying funds take a dive, the guarantee could prove quite valuable. Take a look at the first nearby chart. It assumes a 60-year-old invests \$100,000 in a product with features and fees available today, just ahead of a steep bear market. The chart uses U.S. market data from this decade, so our hypothetical buyer experiences the bear market of 2000-2002, the subsequent rally, last year's slide and this year's rebound.

The bottom line is that, as of Oct. 31, our now-69-year-old has approximately \$60,000 in his underlying funds. On the other hand, next year his benefit base will stand at \$150,000, thanks to the 5%-a-year upward adjustments from his guarantee—entitling him to annual lifetime income of \$7,500.

The second chart shows what happens if the investment is made at the front end of a rally. In 2003, the starting point here, the Standard & Poor's 500-stock index returned 28.7%. The investor's gain, less fees, is locked into his benefit base. So are gains in 2004 and 2006. As stocks fell last year, the owner's fund balance fell far below the benefit base. Still, as of Oct. 31, the owner is eligible for annual lifetime income of about \$8,500.

## *Weighing the Cost*

**QUESTION:** *How should the steep fees play into a buying decision?*

**ANSWER:** Critics often argue that the products are destined to disappoint because the fees eat up about a third of the stock market's average return of 9.6% since 1926, as calculated by Vanguard Group Inc. Look at it this way: If fees are 3.5% a year coming out of your fund investment, and the guaranteed minimum benefit base is rising at 5% a year, then in effect you have to earn more than 8.5% in the market to beat the minimum increase in any year.

But Caleb Callahan, director of investment services at ValMark Securities Inc., Akron, Ohio, notes that the market gets to its average "with some extreme ups and downs." In other words, the big years can deliver high-enough returns to cover the fees—and still provide a generous boost to the benefit base.

He thinks some of the products make sense for certain consumers, alongside low-cost investments. He advises consumers to be on guard for versions that allow insurers wide leeway to bump up fees.

The safety net provided by the annuities gives people the fortitude to stay in the market as they approach retirement, by "changing investor psychology," says Craig Hemke, founder of BuyAPension.com, a site focused on immediate annuities.

## *Final Warnings*

**QUESTION:** *Any other caveats?*

**ANSWER:** There are potentially lower-cost alternatives. For instance, if you are ready to draw retirement checks, you should ask your financial adviser about immediate annuities, under which you pay an insurer a lump sum for an income stream that is guaranteed for either your lifetime or a specific period.

Unfortunately, finding a financial adviser knowledgeable about the variable-annuity guarantees is tough. About 10% to 15% of advisers are behind most of the sales in recent years, and many others are put off by the complexity, says Ramy Tadros, head of the insurance practice at consulting firm Oliver Wyman.

At [Raymond James Financial Inc.](#), an insurance unit identifies products with the most consumer-friendly features. Current top sellers are from Jackson National, MetLife, Prudential, [Lincoln National Corp.](#) and Ohio National Life Insurance Co. [Annuityfyi.com](#) is one of few Web sites providing basic comparative information. (To learn more about the cost of immediate annuities, you can visit sites such as [immediateannuities.com](#).)

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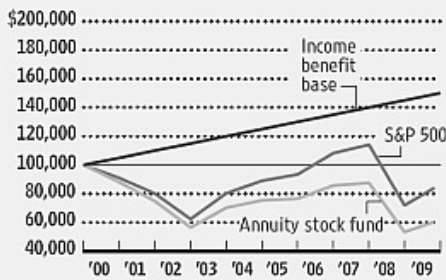
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## Keeping Track of a Variable Annuity's Guaranteed Stream of Payments

These hypothetical examples, using annuity features available today and actual returns for the Standard & Poor's 500-stock index, show how different stock-market environments affect the benefit base from which an annuity's guaranteed minimum income payments are calculated.

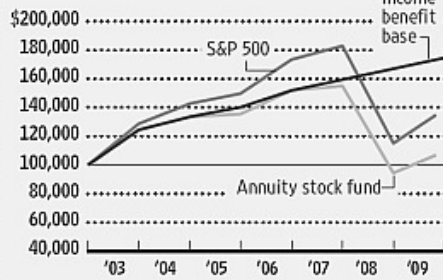
### Buying Right Before a Bear Market

The annuity's stock fund tanks and doesn't catch up to the benefit base



### Good Times, Then a Downturn

Good years boost the benefit base beyond the contractual minimums



Notes: Annuity stock fund has 3.25% annual expenses. Benefit base grows at a minimum 5% simple interest. S&P 500 and fund returns are through October.

Sources: Raymond James, Morningstar