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## Big retirement choice: annuities or mutual funds

### IT'S YOUR BUSINESS

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**Q: I am a public school teacher with the Princeton Regional High School District and my husband is a professor at Rutgers University. We can either chose annuities or mutual funds in our 403(b) retirement plan. What are the pros and cons of each?**

The problem: annuities in retirement plans.

Over 80 percent of 403(b) retirement assets are invested in tax sheltered annuities, while only 20 percent are invested in mutual funds. In New Jersey, the percentage invested in tax sheltered annuities is even higher. At face value this sounds harmless, but hiding just underneath the surface is a very profitable, little talked about secret that is unnecessarily costing investors billions of dollars.

Insurance companies originally developed annuities so investors could invest their money and have all interest, dividends and gains sheltered from taxation — thus the term "tax shelter." Then, in their infinite wisdom, they came up with the idea of offering their tax shelters inside of employer sponsored retirement plans.

If you only remember one thing from this article, it should be: 401(k), 403(b) and 457 retirement plans are already tax shelters!

#### Pros and cons of annuities in a 403(b).

One pro of annuities is the option for a fixed return — thus the term "fixed annuity". Investors are generally promised a fixed interest rate for up to one year, after which, the rate resets each year. Unlike a certificate of deposit, however, a fixed annuity is not guaranteed by the FDIC. Another con of annuities is the high costs built into the other type of annuity, the variable annuity.

Like a mutual fund, variable annuities allow investors to participate in the long-term benefits of stocks and bonds. But here comes the big dirty secret: In addition to the underlying expenses inside the actual investments, the insurance company applies a second set of expenses called a mortality and expense risk charge.

How big is this M&E problem? Approximately \$200 billion dollars are invested in variable annuities inside of 403(b)s. Applying the average M&E charge of 1.4 percent on top of the underlying expenses results in a \$2.8 billion problem.

Let's look at our two educators who each invest \$6,000 per year for 20 years. Educator one invests in a 403(b) using an annuity. Although her investments generate an annual return of 9 percent, the M&E charge brings the return down to 7.6 percent. Educator two invests in a 403(b) using mutual funds with equal risk and generates a return of 9 percent. Educator two is \$44,200 wealthier, simply by avoiding the M&E charge inside the annuity.

Do not forget, the M&E risk charge continues as long as you have your money invested in a variable annuity — destroying your wealth well after you have stopped contributing.

#### Pros and cons of mutual funds in a 403(b).

One very big pro of mutual funds are their low costs, as discussed above. Unlike annuities, mutual funds do not have an M&E risk charge. Another pro of mutual funds are their transparency. Unlike variable annuities, mutual fund prices are readily accessible on a daily basis through newspapers, finance web sites or by calling the mutual fund company directly.

One con of mutual funds is their lack of a fixed interest rate. Unlike fixed annuities, mutual fund companies offer money market mutual funds that provide a variable interest rate. This can work to your advantage in a rising interest rate environment, as the money market's interest rate would rise as well.

The solution: Choose what is right for you.

For some investors, earning a fixed rate, sometimes lower than the inflation rate, is the right choice to reduce risk. For most investors, generating a rate of return well above the inflation rate is the right choice to reduce the risk of losing money in real dollars.

When comparing annuities versus mutual funds in a tax-sheltered retirement plan, look out for your own best interests, not the insurance company's best interests.

Often overlooked: Many investors think they are trapped in their 403(b). They are not.

Most employers allow employees to move from an annuity-based 403(b) to a mutual fund-based 403(b) and vice versa. The transfer is called a 90-24 transfer. Not only is the transfer easy, but there are no tax ramifications.

Once an employee terminates service with an employer, they can generally roll over their 403(b) to another employer's retirement plan or, better yet, into an Individual Retirement Account (IRA), again without tax ramifications.

Action steps: Be sure you have choices.

Make sure your employer offers choices. Unlike the corporate world, where annuities have almost been phased out, most non-profit employers will allow both annuities and mutual funds. If your employer only offers annuities, which is common in New Jersey, ask them to add a mutual fund option.

Remember, you have worked hard for your money — do not waste it on unnecessary fees.

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