Featured Stories

Annuities the Next 401k SNAFU? Advisers Offer 6 Reasons Why

By Chris Carosa | February 17, 2010

After a series of Congressional comments, regulators move to take action. There's a hot, new investment product making lots of positive headlines in the financial press. Washington, succumbing to its own version of the behavioral psychology phenomenon known as "recency," formally adopts this product as a panacea to investor woes. There is much rejoicing among every 401k fiduciary as these new guidelines hold the promise of reducing fiduciary liability.

Fast forward two years. A market turnaround exposes the flaws of this neophyte product. Investors grumble. Congress holds hearings. Nothing gets done, but, again, regulators maneuver to take action. The world of the 401k fiduciaries waits. Have they unknowingly taken on more fiduciary liability than they have bargained for?

Sound familiar? Are we rehashing the past and present of the 401k Target-Date Fund SNAFU? Or are we seeing the present and future of the coming 401k Annuity SNAFU?

Pension & Investments reports, "In a joint agency RFI published in today's Federal Register, the Treasury and Labor departments expressed concern that defined contribution plans generally make only lump-sum payments available to plan retirees" ("Government wants input on DC plan annuity payouts," February 2, 2010). The report goes on to quote Robert Reynolds, president and CEO of Putnam Investments, who, according to a company press release, "endorsed requiring retirement plan sponsors to offer federally backed annuity." In addition to its mutual funds, Putnam sells annuities via Hartford and All State.

Now, the government is looking for your ideas on the pluses and minuses of requiring the inclusion of annuities as an option in 401k plans ("Treasury, Labor Dept. seek info on using annuities in 401(k)s," *Investment News*, February 1, 2010). According to the periodical, the Treasury and Labor Department "also seek an explanation why most retirees, when faced with a choice of a lifetime income option or a lump-sum distribution, choose the lump-sum option."

FiduciaryNews asked several prominent independent investment advisers what they felt about this initiative. They revealed six major concerns every 401k fiduciary must consider regarding annuities.

1) **Annuity-based products have minimal fee transparency** – In an era when 401k fees have become almost an obsession, one might feel the last thing the DOL wants to do is to require plans include a product where it is notoriously hard to determine the product's underlying fees. "In my experience, it has been extremely difficult

platforms because she can easily "obtain administration and record keeping costs and, if there is revenue sharing involved, see it broken out for each fund." She also likes the ability to see an illustration "showing how much revenue is being generated from Sub-TA and 12b-1 fees and how that revenue offsets the costs of the plan." Her warning for plan fiduciaries: "I have yet to see an illustration like this on any annuity-based 401(k) product."

2) **Plan participants might have difficulty understanding annuities as opposed to mutual funds** – More than fees, Scott Holsopple, President, Smart401k focuses on the process a plan sponsor/fiduciary would go through to prudently select an annuity option(s) for their plan. "This process," says Holsopple, "needs to address not only fees, but other things such as the insurer's stability, payout to the participant, restrictions (portability, surrender charges, etc…) and how a participant will be educated on the option. If direction regarding the evaluation process isn't provided by the government and providers don't greatly simplify their product (fees, restrictions, etc), annuities may only add to the confusion that many participants and plan sponsors feel regarding 401k plans."

3) **Annuities may encourage bad investing behavior** – Chad Griffeth, AIF, Co-Founder, BeManaged sees a much more subtle – and potentially more devastating – concern. "In our interactions with participants, we have found that few participants understand risk and how much exists in their portfolios. If the market were to suffer another correction, the fear would be the participants would overcompensate and commit too much money into an annuity during a down turn, dramatically affecting their retirement income. Hence, the investor's attempt to mitigate risk could in fact cost them significant income during retirement. This 'income lock-in risk' needs to be considered, as the behavioral impact of investors' decisions is well documented, as well as the true impact of education, which is minimal." Griffeth is quick to add he doesn't think "annuities for participants are a bad idea, but the risks involved are complicated, and thus I believe one of the distinct reasons why employers have been slow to embrace them as an investment option."

4) **The real issue isn't annuities, it's a lack of retirement savings** – Griffeth's concern about bad behavior really emphasizes the greater issue of investors not saving enough to begin with. Paul G Escobar, Managing Director, Retirement Planning, US Wealth Management says, "Annuities don't actually address the issue – namely that most baby boomers don't have enough saved. This is a combination of factors from not having had a 401k plan to not having participated at all or not having participated enough." In addition, Escobar cites "withdrawals for loans, hardships and cash outs at job changes" as other reasons for participants not having sufficient savings to retire.

5) **Annuities are really tax-advantaged insurance products, not retirement vehicles** – Historically, insurance companies offered annuities to people seeking both to defer taxes and simultaneously obtain life insurance. Since 401k plans already offer a tax sheltering benefit, any costs (both direct and indirect) associated with maintaining an annuity's tax-advantaged status are paid by 401k investors without providing any value. In addition, the additional cost of the life insurance may also not add value. "The death benefit was triggered in only 1% of all policies from 2002-2004, according to Limra International, an insurance-industry research group," says Aaron Skloff, AIF, CFA, MBA, Chief Executive Officer, Skloff Financial Group. He adds, "The actual amount paid out may not justify the cost of the benefit. If you think you will fall into that 1%, a life insurance policy to cover a $10,000 or $50,000 shortfall might make more sense." This actuarial reality may address the question as to why most people – and why most professional advisers recommend – roll over their retirement savings in a lump-sum rather than take an annuity option.

6) **Using annuities in 401k plans suffers from too many practical obstacles** – Roger Wohlner, a financial advisor with Asset Strategy Consultants in Arlington Heights, Illinois, feels, "The idea of introducing annuities has some appeal on a conceptual level." He says this is because "401k participants have seen wide fluctuations in their account values due to the huge market swings of the past couple of years." But, he cautions, "The practical application of this idea is not so simple. Among the issues to consider are the often high and less than transparent fees that many commercial annuity products carry. Additionally, what criteria will be set to determine which insurers are eligible to have their products included; will there be a standard payout scale or formula for participants of a given age; will the government stand behind the fiscal health of the insurers; will there be limits

Wollner spells out his ideas in more detail in his February 11, 2010 blog "Annuities in 401(k) Plans My Questions and Concerns."

Interestingly, on the heels of an *Investment News* story on questionable sales practices ("California couple sues VALIC over its annuity sales practices," *Investment News*, January 17, 2010), none of the above advisers mentioned the very practical concern of the marketing of annuities. Currently, unlike a mere Blue Sky filing like mutual funds (where the Securities and Exchange Commission administers the Investment Company Act of 1940 to regulate all mutual funds) insurance companies must obtain approval from each individual state before offering a specific insurance product, including annuities. Some of the most attractive – and some feel controversial – annuities today are offered in states (like Florida) but cannot be offered in other states (like New York). If a company operates in multiple states, how does it handle its choice of annuities?

It would seem the idea to mandate the presence of annuities in 401k plans may have originated from last year's significant drop in the values of 401k plans. As we've earlier reported ("Readers Select Top Fiduciary Stories of 2009: #5 401k Plans Recover Significantly by Year-End," February 11, 2010) time may have cured that particular issue.

If you'd like to officially register your comments with the Department of Labor, they have provided this link to review for your convenience: http://www.regulations.gov/search/Regs/home.html#documentDetail?R=0900006480a898af A spokesman for the suggested to FiduciaryNews.com this part of the document that will help you most (FiduciaryNews.com is grateful for the help provided by the Department of Labor in providing the following information):

SUMMARY: The Department of Labor and the Department of the Treasury (the "Agencies") are currently reviewing the rules under the Employee Retirement Income Security Act (ERISA) and the plan qualification rules under the Internal Revenue Code (Code) to determine whether, and, if so, how, the Agencies could or should enhance, by regulation or otherwise, the retirement security of participants in employer-sponsored retirement plans and in individual retirement arrangements (IRAs) by facilitating access to, and use of, lifetime income or other arrangements designed to provide a lifetime stream of income after retirement. The purpose of this request for information is to solicit views, suggestions and comments from plan participants, employers and other plan sponsors, plan service providers, and members of the financial community, as well as the general public, on this important issue.

DATES: Comments must be submitted on or before May 3, 2010.

ADDRESSES: You may submit written comments to any of the addresses specified below. Any comment that is submitted to either Agency will be shared with the other Agency. Please do not submit duplicates.

Department of Labor. Comments to the Department of Labor, identified by RIN 1210-AB33, by one of the following methods:

Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.

E-mail: e-ORI@dol.gov. Include RIN 1210-AB33 in the subject line of the message.

Mail: Office of Regulations and Interpretations, Employee Benefits Security Administration, Room N-5655, U.S. Department of Labor, 200 Constitution Avenue, NW., Washington, DC 20210, Attention: Lifetime Income RFI.

All submissions received must include the agency name and Regulation Identifier Number (RIN) for this rulemaking. Comments received will be posted without change to http://www.regulations.gov and http://www.dol.gov/ebsa, and made available for public inspection at the Public Disclosure Room, N-1513, Employee Benefits Security Administration, 200 Constitution Avenue, NW., Washington, DC 20210, including any

Internal Revenue Service. Comments to the IRS, identified by REG-148681-09, by one of the following methods:

Mail: CC:PA:LPD:PR (REG-148681-09), Room 5205, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

Hand or courier delivery: Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-148681-09), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224.

Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments (IRS REG-148681-09).

All submissions to the IRS will be open to public inspection and copying in Room 1621, 1111 Constitution Avenue, NW., Washington, DC from 9 a.m. to 4 p.m.

FOR FURTHER INFORMATION CONTACT: Stephanie L. Ward or Luisa Grillo-Chope, Office of Regulations and Interpretations, Employee Benefits Security Administration (EBSA), (202) 693-8500 or Peter J. Marks, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service, Department of the Treasury, at (202) 622-6090. These are not toll-free numbers.

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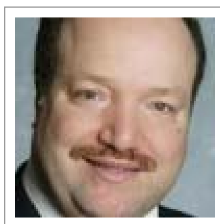

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