



The Real Cost of a Variable Annuity—2008 Update

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A variable annuity is a personal retirement account that brings together the best features of mutual funds and insurance. In a variable annuity, assets are invested in a variety of underlying funds called subaccounts and grow tax deferred until withdrawn. Today virtually all variable annuities permit contract owners to choose from a diverse group of underlying funds with a wide range of investment objectives. This flexibility allows individuals to tailor an investment strategy to meet their specific financial needs and objectives. When investors are ready to start using the savings they have accumulated, variable annuities offer a range of payout options, including income payments that cannot be outlived.

Variable annuities also offer a number of optional guarantee features that can reduce investment risk and provide other important insurance protections. By choosing one or more of these guarantees and paying an additional charge, investors can utilize the guarantees to enhance the personal retirement plan provided by their variable annuity.

In return for the important insurance benefits variable annuities provide, investors pay what are commonly referred to as “insurance charges.” These charges allow the investor to receive income that can’t be outlived at rates set forth in the contract at the time of purchase. In addition, these charges secure the guarantee that insurance and administrative expenses will not increase, provide a death benefit protecting beneficiaries, and also may provide for other additional optional guarantees as selected by the investor. It is important to note that investors also pay an investment management fee charged by the underlying funds in the variable annuity. This fee covers the cost of having investment professionals manage the funds and is similar to the fees paid for publicly available mutual funds.

It is often assumed that the management fees for the funds underlying variable annuity subaccounts are generally the same as the management fees for mutual funds that are sold to the public, and that if a person purchases a variable annuity instead of a mutual fund, the cost differential will be approximately equal to the insurance charges.

This view is too simplistic. It overlooks some important fundamental differences between the underlying funds offered as investment options in variable annuities and publicly available mutual funds.

According to 2008 Morningstar data, the average annual expense ratio for publicly available mutual funds was 1.22%. The comparable figure for underlying funds in variable annuities was 0.94% — 0.24% lower than mutual funds. These figures show that the lower expense ratios of underlying funds in some variable annuities may actually offset part of the additional insurance charges and suggest that, on average, the actual cost differential of the two products is about 1.18%.

Figure 8-1 Fees and Expenses—Mutual Funds vs. Variable Annuities

	2008 Average Expenses	
	Mutual Funds	Variable Annuities
Fund Expense	1.22%	0.94%
M&E	-	1.21%
Administrative	-	0.16%
Distribution	-	0.09%
Total	1.22%	2.40%
DIFFERENCE		1.18%

Source: Morningstar, Inc.

Why are the average expense ratios for publicly available mutual funds higher than those of underlying funds in variable annuity subaccounts? The difference may be attributable to several factors, but a primary reason is the additional handling and administrative expenses incurred by mutual funds that are sold to the public. These mutual funds have thousands of individual shareholders, and each shareholder has an investment account that must be administered by the fund or another service provider. In the case of variable annuities, however, most of these functions are handled by the insurance company and are reflected in the insurance and administrative charges. The insurance company is, in effect, one “account holder” of the underlying mutual fund.

The potential for variable annuity underlying fund expense ratios to be lower than publicly available mutual funds is an important factor to keep in mind when considering whether to invest in a variable annuity. By choosing carefully and comparing the costs of the investment funds in a variable annuity to those of publicly available mutual funds, the additional cost of the variable annuity may be partially offset by the cost savings offered by the annuity subaccounts. The point to remember is this—although there will be charges for the valuable insurance features of a variable annuity, depending on the product selected and the underlying investment options offered, the total cost differential between the variable annuity and publicly available mutual funds may be less than one might think.

Figure 8-2

Average 2008 Expense Analysis by Investment Category

(numbers in percents)

	Mutual Fund Fund Expense	Variable Annuity Fund Expense	Variable Annuity Total Expense
Balanced/Hybrid			
Conservative Allocation	0.86%	0.58%	2.43%
Moderate Allocation	1.02	0.70	2.42
World Allocation	1.16	0.95	2.56
Target Date	0.66	0.34	2.80
Core Bond			
Short-Term Corporate	0.91	0.72	2.05
Short-Term Government	0.88	0.77	2.18
Intermediate-Term Corporate	0.96	0.71	2.15
Intermediate-Term Government	1.03	0.73	2.14
Long-Term Corporate	0.84	0.81	2.26
Long-Term Government	0.89	1.08	2.43
Domestic Stock			
Bear Market	1.93	1.65	3.13
Small Cap	1.48	1.05	2.53
Mid Cap	1.41	1.04	2.50
Large Cap	1.20	0.92	2.43
Natural Resources	1.46	1.12	2.57
Real Estate	1.43	1.13	2.59
Specialty	1.69	1.33	2.88
Utilities	1.38	1.09	2.48
High Yield/Specialty Bond			
Bank Loan	1.38	1.12	2.55
High Yield	1.20	0.89	2.31
Multi-Sector Bond	1.14	0.85	2.33
International Stock			
Developed Markets Stock	1.45	1.04	2.51
Emerging Markets Stock	1.72	1.48	3.02
Japan	1.78	1.64	2.95
Pacific	1.92	1.54	2.96
International Bond			
World Bond	1.13	0.93	2.31
Emerging Markets Bond	1.33	1.08	2.58
Money Market			
Money Market	0.58	0.57	1.96

Source: Morningstar, Inc.

NOTE: The expense data used in this chapter is based on the audited expense ratios from the filings with the U.S. Securities and Exchange Commission by all publicly available mutual funds in the Morningstar database and by all variable annuity underlying funds in the Morningstar database. The expense ratios of all publicly available open-end mutual fund share classes and all variable annuity funds were averaged using a non-asset-weighted average. The numbers do not attempt to address the total “carrying cost” of the various fund share classes or annuity policies. For example, they do not address differing “loads” across retail mutual fund share classes and do not back out differing contingent deferred sales charges at the annuity policy level. All product/subaccount charges come from the product prospectuses.

It is important to remember that this data is for a limited time frame, and caution is required in using the results. While it may be appropriate to cite this data in general discussions about variable annuities, the results represent industry averages and therefore do not reflect individual mutual fund or variable annuity product lines and/or any differences that may exist between the proportion of publicly available mutual funds that have certain asset-based charges, such as Rule 12b-1 fees, as compared to the proportion of variable annuity underlying funds that have these types of charges.