DOW THEORY FORECASTS®

Variable annuities a good fit for some investors

Variable annuities should be sized up carefully.

Underwritten by insurance companies, variable annuities offer a range of stock and bond investments, called subaccounts, typically managed by mutual fund companies. Importantly, overall performance fluctuates depending on the returns of the subaccounts.

Variable annuities grow tax-deferred, making them a good way to save for retirement. If you invest with after-tax dollars (there are no contribution limits like an IRA), gains are taxed as income when withdrawn, with no taxes on the principal. However, if you take withdrawals prior to age 59-1/2, you may be required to pay income tax and a 10% penalty.

Investors can receive income in a lump sum, via periodic withdrawals, or by annuitizing, which converts an account into a guaranteed stream of payments. Investors who annuitize surrender any future growth in exchange for payments that can last for life. If you live long enough, the income payments might surpass what you invested.

Variable annuities offer a variety of death benefits, which guarantee a certain payout to beneficiaries and typically bypass probate. One popular benefit is called return of premium; beneficiaries receive either all contributions or an annuity's accumulated value, whichever is higher.

Unfortunately, variable annuities can be very expensive. By our math, traditional variable annuities average an annual expense ratio of around 1.16%, which includes mortality and administrative costs. After layering on management fees for underlying subaccounts that often exceed 2%, total annual expenses can push well past 3%.

Many variable annuities also charge sales commissions, some as much as 5.5%. And some levy fees for special features, called riders, like long-term-care coverage or guaranteed minimum income payments. Finally, if you withdraw money within a certain period after the initial investment — typically within six to eight years — you could get hit with surrender charges, which run as high as 9%. Some annuities allow for partial withdrawals without penalty.

Our advice

Variable annuities are a decent choice for investors looking to boost tax-deferred savings, particularly those who have maximized contributions to an IRA or 401(k) plan. We looked for low-cost contracts with no up-front charges or surrender fees. We focused on annuities offered by large insurance companies with ratings of A+ or higher from A.M. Best, which gauges an underwriter's financial soundness.

While we don't have a clear favorite, Fidelity's Personal Retirement Annuity charges only 0.25% annually and offers a diverse selection of subaccounts with expenses starting at only 0.10% per year. The annuity has 57 investments to pick from, including portfolios managed by PIMCO, Templeton, and Morgan Stanley.

If you already own a variable annuity but wish to switch, consider a tax-free exchange. Note that you might be required to pay surrender charges on the old annuity.