ANNUITIES: THE NEXT WAVE OF CUSTOMER DISPUTES
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Annuities are being sold in record numbers and attracting the attention of both regulators as well as the plaintiffs' securities bar. The biggest abuses involve elderly, retired persons who are being sold annuities through "free" financial seminars and telemarketers. Annuities abuse appears to be the new, growing wave of complaints, both private and public.

What Are Annuities
Annuities essentially are insurance products wrapped around an investment account. There are two basic types of annuities products. Fixed annuities carry a "guaranteed" rate of return and protection of principal. The other form of annuity, variable annuities, generally consists of insurance plus a portfolio of mutual funds that rise and fall as the stock market fluctuates and the value of the annuity, consequently, will and does fluctuate.

Annuities are, by far, the most lucrative financial product that a broker, financial advisor or insurance agent can sell, generating sales commissions of as much as 12% of the amount invested, far more than the comparatively small commissions generated by the sale of a bond or mutual fund. Given the large commission that can be generated by selling an annuity, there is a great financial incentive for investment advisors, brokers and insurance agents to sell as many annuities as possible. By contrast, the commissions generated by selling a customer a balanced portfolio of fixed income bonds, government notes or other secure, guaranteed fixed income product are a mere pittance.

As a general rule, however, most investors would be better served by purchasing insurance separately and building a conservative, low cost, low commission, readily accessible and liquid portfolio of laddered bonds and secure fixed income assets with some amount of indexed or low cost mutual funds.

The Risks of Annuities
While rarely discussed by those who sell them, other than in the fine print of the prospectus understandable by only the very sophisticated, there are substantial risks associated with purchasing annuities. Those risks, for the most part, more than outweigh the proclaimed benefits of buying an annuity.

The biggest risk of purchasing an annuity is the substantial penalties charged by the companies selling the annuity for early withdrawals beyond a small, annual percentage permitted without penalty. Since most annuities are sold to elderly, retired persons, the very people who may need to quickly withdraw their money in the event of death or other life crisis, the early withdrawal penalties can be disastrous. Annuities are rarely, if ever, beneficial to elderly persons who may need to access their funds quickly or who die before the annuity matures. In many cases, if the holder dies during the annuity period, the beneficiaries cannot redeem the annuity without incurring and paying an early surrender charge.

The second biggest risk of purchasing an annuity is the substantial annual costs associated with owning one. An investor seeking a safe, guaranteed annual rate of return and safety of principal can have a reputable broker or advisor create a portfolio of diversified municipal, government or corporate bonds, of various maturities. The commissions in purchasing quality bonds is low and there is no annual carrying cost once the bond is purchased. If the portfolio is properly laddered (i.e. consists of bonds with different maturities so that a percentage of the total amount invested matures each year) the bonds can be held to maturity with sufficient liquidity to cover any unanticipated need for immediate cash. By contrast, many annuities carry annual fees of as much as 3% or more of the amount invested, money that does not provide any return for the investor and reduces the total yield of the annuity. While annuities can sound attractive and offer higher yields than otherwise available through direct fixed income investments, an investor must carefully weigh the impact of these on-going, annual fees to understand the true yield of an annuity.

Another very common abuse in the sale of annuities is the purchase of an annuity through an IRA, Keogh or other retirement account. Annuities do have certain tax benefits (a discussion of which is beyond the scope of this article), but any tax advantages are absolutely worthless when an annuity is purchased in an IRA or other tax-deferred retirement plan. As a rule, it never makes sense to purchase an annuity through an IRA or retirement plan and anyone who tries to sell one to a retirement account should be suspect.

The Growth of Annuities' Abuse

As sales of annuities have soared, so have investor complaints related to them. Increasingly aggressive marketing has made annuities one of the hottest investments around, particularly for unsophisticated, elderly investors who were burned by the "tech-wreck" market collapse of 2000 and who are seeking a safe haven for their retirement funds. Money invested in variable annuities totaled ***$994 billion*** at the end of 2003, up from $771 billion in 1998. According to the NASD (The National Association of Securities Dealers), annuities complaints were at issue in approximately 600 arbitration cases in 2004, more than twice the number from three years earlier. Of the seven types of securities typically involved in customer securities arbitrations, annuities were the third most common, behind stocks and mutual fund abuses.

Sellers of annuities have caught the attention of regulators across the country. In February, for example, the California Attorney General and the California Insurance Commissioner filed a lawsuit against a group of companies and individuals that state officials said had tricked retirees into using their retirement investments to buy annuities. According to the complaint, using telemarketers and seminars under the guise of "estate planning", hundreds of millions of dollars worth of annuities were sold to elderly retirees for whom the product was unsuitable. According to regulators, the annuities were sold as a way to allay retirees' fears of outliving their assets when, in fact, the annuities ate up substantial amounts of their retirement funds in fees, commissions and expenses.

"Switching" Abuses

Recently, Waddell & Reed, one of the country's oldest mutual fund companies, paid $16 million to settle charges brought by regulators saying that it fleeced investors by "switching" them into financial products, principally annuities, that benefited the brokers and the firm at their customer's expense. The NASD regulators charged the firm with orchestrating a concerted campaign to move investors' from one variable annuity to another. Given the large commissions generated on the sale of an annuity, the financial incentive for a broker to "switch" an unsuspecting customer from one annuity to another is a strong motivation for abuse. When a customer is "switched" from one annuity to another, the investor typically incurs substantial surrender charges and is locked into another long term commitment with the early withdrawal period starting all over again. Rarely, if ever, does it make financial sense to "switch" from one annuity to another. Older annuities, particularly fixed annuities, typically are the better investment and have shorter termination dates.

Be Careful When Considering Annuities

Annuities may be a useful financial investment for a limited number of individuals. They should, however, only constitute a part of an overall, diversified investment portfolio; never be purchased in a retirement account and the costs, lock-in periods, annual fees and charges must be considered when comparing an annuity with alternative investments. More often than not, the same objectives can be accomplished with alternative investments at a lower cost and with greater liquidity.

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