Employers Offer New 401(k) Option: Annuities

By Aleksandra Todorova
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WITH PENSION PLANS on the fast track toward extinction, companies are exploring another alternative that will provide their employees with a steady stream of retirement income: annuities in their 401(k)s.

When choosing to invest this way, employees will have the ability to direct all or part of their contributions into annuities — as opposed to mutual funds, which are the primary 401(k) investment choice. In return for each contribution, the employee receives a certain amount of guaranteed lifetime income that will kick in after they retire, typically at age 65.

It's a simple, but controversial approach. Buying an annuity within a retirement account is typically a terrible idea[1]. Not only are annuities expensive (investors pay an additional layer of fees for the income guarantee), but buying one within a tax-deferred account is simply unnecessary, as annuities already have tax-deferred growth built in.

So why, then, are employers introducing these to their 401(k) plans?

The insurance companies that have so far rolled out these products — including The Hartford, MetLife, Genworth and Prudential Financial — say they fill a widening gap in retirement planning, namely, figuring out how to spend your retirement savings. "With 401(k) plans, traditionally it's been all about accumulation and when someone ends up with a big lump sum, they've got to figure out how to turn it into income for a lifetime," says Fred Conley, president of the institutional retirement group at Genworth. With annuities, the insurance companies argue, the retiree doesn't have to do that math. They receive a certain payout each month, which is guaranteed to continue for as long as they live.

MetLife, Genworth and Prudential have roughly 60 clients that have added annuities to their 401(k) plans and The Hartford currently has one. But those numbers are expected to grow over the next few years. "Everyone's asking about them," says Robyn Credico, national director for defined contribution consulting at Watson Wyatt, an employee benefits consultant. The concept is still so new that it may take a while for employers to jump on the bandwagon, she says. But if they're successful, they could become commonplace in the next two or three years.

PayChex, a payroll and human resources outsourcing firm, added Genworth's ClearCourse annuity to its 401(k) plan last May. Since then, it has become the company's most popular new product to ever be rolled out, says Will Kichta, vice president of organizational development. So far, 569, or nearly 6% of the firm's 401(k) participants, have signed up, with enrollment up by 20% since the beginning of the year alone. Part of that momentum could be a result of increased concerns about the economy's slide toward recession and the stock market's volatility, both factors that could add to these investments' popularity in the months to come.

The good news is the annuities that employees will be offered in their 401(k)s have to pass the much stricter scrutiny of their retirement plan's sponsor, greatly reducing the odds of any shady or mismanaged offerings entering the mix. "These cannot be yesterday's annuity products," says Charlie Ruffel, CEO of PlanSponsor.com, a research and publishing firm that focuses on the retirement marketplace. "They have to be flexible, much less expensive — completely different than the annuity products companies have been pushing down people's throats for the past 10 years."

The products offered by the insurance companies so far have addressed some of these concerns. Thanks to institutional pricing, for example, they're much cheaper than the annuities you could buy on your own. They're also flexible, allowing employees to stop investing at any time or to sell their accumulated holdings with no surrender charges.

But there's still room for improvement, says Christopher Cordaro, chief investment advisor at wealth-management firm RegentAtlantic Capital. "The concept is great and those are great first steps. But I'm hopeful that we'll continue to see the offerings evolve and get better over time." Among the products' drawbacks, he points to insufficient

disclosure of certain features, such as costs and investment returns, making it difficult for consumers to compare different products.

Here are a couple of things to consider before putting your 401(k) contributions into an annuity.

Returns are difficult to figure out

When choosing among the mutual funds offered within your 401(k), looking at performance and expenses is a clear way to evaluate a fund within its investment category. But things get much foggier when annuities come into the picture.

Knowing the annuity's return, for example, would come in handy if you were wondering whether it's a viable alternative to the bond funds in your portfolio. But while all annuity products give you an account of the guaranteed income you've purchased so far, figuring out the actual return on your investment is far from easy.

Assuming that you contribute $100 a month starting at age 40 until retirement at 65, Hartford's Lifetime Income annuity will pay you $5,570 a year for as long as you live. With MetLife's Personal Pension Builder you will receive only $4,143 a year. But how does that compare with the option, for example, to continue investing in **Vanguard's Total Bond Market Index** (VBMFX[2]), which over the past 10 years has returned an average 5.71% annually?

According to Cordaro's calculations, assuming that you live until age 85, the annuity payouts translate to a 4.5% return for MetLife and 6% for The Hartford. (With either policy, returns increase the longer you live.) The Hartford's return is quite reasonable, given current bond returns, he notes, but that's not the case with MetLife's product. "What's needed is a way for participants to do the same comparison," he says.

They're still not right for everyone

They may be cheaper and more flexible, but just because they're available in your 401(k) doesn't mean annuities are right for you. Granted, the younger you are when you start investing, the higher payouts you'll get — but they're not for someone who's 25 or even 30, Cordaro says. "If you're 25, you should really be invested 100% in equities," he notes. "Look at these as you start investing in bonds, in your late 30s or 40s." (And even then, consider only allocating a small portion of your portfolio to annuities that you would have otherwise invested in fixed-income products. Annuities are certainly not meant to make up 100% of anyone's portfolio, even that of a retiree.)

The issue here is that even though some of these products — Prudential's Income Flex and Genworth's ClearCourse, for example — are set up as variable annuities so you can take advantage of the market's upsides, you may still do better with cheaper mutual funds as far as portfolio growth is concerned.

As you approach retirement, a guaranteed minimum return may be beneficial since you won't have to worry about your portfolio shedding 10% or more right before you retire. (Read our story[3] for more on the dangers of tapping your nest egg in a bad year.) But it's unnecessary when you have a longer time horizon and, therefore, the chance to reap bigger market gains. "If I had 10 or 15 years to use that money, the chances that it'll grow by 5% or less annualized over that period is extremely small," says Steven Podnos, a fee-only financial planner in Merritt Island, Fla. "You can take insurance [that it doesn't], but you'll pay for it."

Those additional expenses eat into your returns. Prudential's Income Flex, for example, has an expense ratio that ranges from 1.5% to 2%, while Genworth's product charges 80 to 90 basis points for the income guarantee, on top of underlying fund expenses. And should you decide to get out of these investments if you're not happy with the performance — or simply leave your job and roll over your account to an IRA — you will have paid those additional costs for nothing.

Assessing 401(k) Annuities

How they work	Some products (including **MetLife's** Personal Pension Builder, **The Hartford's** Lifetime Income) work like deferred fixed-income annuities. Each contribution buys you a certain amount of guaranteed lifetime income, determined by your age and the current interest rates. **Prudential's** Income Flex and **Genworth's** ClearCourse work like deferred variable annuities. Each contribution increases your account value, you have a guaranteed minimum rate of return, but if the market does better than that, so does your portfolio.
Costs	**Prudential:** 150-200 basis points total;

	MetLife: 70-100 basis points total; **Genworth:** 80-90 basis points on top of underlying mutual fund expenses (undisclosed); **The Hartford:** undisclosed.
Cancellation/ surrender charges	None. Employees can switch their funds into other 401(k) investments at any time. **MetLife** charges a 1% penalty for hardship withdrawals when these come out of an employee's Personal Pension Builder portfolio.
Changing your job	You can leave the investment in the plan, get a certificate guaranteeing you the lifetime income accumulated so far, or you can roll over the account value in an IRA. With rollover, you lose the guarantee. **The Hartford** has an IRA rollover option where you keep the guarantee and continue purchasing shares at institutional prices. With **Genworth's** IRA rollover, portfolio expenses go up by roughly 15 basis points.
Starting withdrawals	At retirement, you will typically be given the option to take a lump-sum payment, to an extent negating the idea of these annuities. You may also be able to elect a single or joint annuitant option. With the latter, your spouse will continue receiving payments after your death. Some products also allow you to add inflation protection, but that will lower your payouts.
Death	If you die before you start taking withdrawals, your beneficiaries can receive the account value or, in some cases, the income accumulated so far. With **The Hartford's** product, for example, the income amount will be actuarially adjusted to the new recipient's age (if they're younger, the payout will be lower). Should you die after you start withdrawals, your beneficiaries receive your remaining account value.

Sources: The Hartford, MetLife, Genworth, Prudential.

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