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## Don't Let the Annuity Industry Raid Empty Nest Eggs

The Retirement Security for Life Act would amend the Internal Revenue Code so that annuity buyers could get a 50% tax deduction on annuity income reaching \$40,000 annually. For the average retiree, the tax break could approximate \$5,000.

The tax deduction, however would be totally offset by the fees and illegal sales practices of one of the most poorly regulated investment products in the country—not to mention one whose existence is unnecessary. The misdoings by annuity salespeople include misleading potential buyers about investment returns and how soon they can access their savings along with generating commissions by convincing the customer to buy a new annuity.

Annuities are a “sucker’s game dressed up to look like a free lunch,” says John Gay, a financial planner in Frisco, TX, who like many of his colleagues believes that retirees would be better off buying zero-coupon T bonds and index funds.

While in the past annuity sellers concentrated on the already-retired market, they are now setting their sites on the Boomers who are about to retire and can't afford to. Some examples:

- In 2006 the National Association of Securities Dealers (now the Financial Industry Regulatory Authority) issued an investor alert regarding annuity sales people conducting workplace seminars in which they convinced employees to retire early, cash out of their 401(k)--in which they could occur tax consequences if they're under 59 ½--and open an IRA which consists of a variable annuity. In one disciplinary case that NASD prosecuted, the broker told the employees, “you

can make as much in retirement as you can at work,” saying that he could generate annual returns of 18%.

- A similar pitch was made to employees at Exxon Mobil workers in 1997: 32 of them bought the broker’s line and lost most of their money. In May of 2006 an NASD arbitration panel awarded the workers \$22 million—one of the largest such awards, including \$3.5 million in damages.
- In May of 2006 Attorney General Eliot Spitzer announced an agreement in which the Hartford Financial Services Group would pay \$20 million in restitution and fines as a result of insurance brokers recommending group annuities to pension plans. A similar agreement was reached with Connecticut Attorney General Richard Blumenthal.

This practice would be shameful enough if annuity sellers were taking an adequate nest egg and putting it into a bad investment; unfortunately currently the average American has saved only one-fifth of what they need—a dilemma no investment product can fix. To retire from a 401(k) account, participants need to have an account balance that’s at least 10 times their salary right before retirement, the formula often used by pension actuaries to calculate the benefit for defined benefit pension plans.

Currently, the average American head of household between age 62 and 65 only has about \$110,000, if you add the median 401(k) account balance to the median rollover IRA balance—or less than twice the median salary of \$61,600 for that age group. The only solution for this shortfall is for Boomers to stay in the “accumulation phase” of investing by continuing to work—and banking most of their paycheck—until they can afford to be in the distribution phase.

The tack taken by annuity sellers targeting retirees is to profit by selling multiple annuities to the same buyer, impose surrender charges on a sale and target people who don’t need them because they are unlikely to outlive their savings. What follows are a

sampling of actions taken against annuity sellers targeting the already-retired in a variety of states.

- In July of this year Florida Governor Charlie Christ signed a law increasing penalties on annuity salespeople who pressure elderly clients to buy annuities they don't need or want. The law increases fines from \$100,000 to as much as \$150,000 for certain "unfair or deceptive annuity sales activities," including "twisting," in which a salesman lies about the benefits of his annuity to get you to sell your current annuity from a different company, or "churning," which is replacing the annuity you have with a new product from the same company. The law also bans the use of professional designations that mislead consumers into thinking the broker has special expertise.
- In 2005 New Jersey launched its Senior Citizen Investment Protection Act, which limits how long annuity sellers can impose surrender charges in the event the annuity owner wants to sell the product. Along with Utah and Washington, New Jersey limits to no more than 10 years the length of time insurers can impose surrender charges.
- That same year the Massachusetts Securities Division convinced Bank of America to let thousands of elderly investors withdraw money from a variable annuity without penalty. In addition, the division issued subpoenas to 15 firms seeking information about the sales to clients age 75 or older.
- In 2004 California passed a law that increased jail time to one year and set a mandatory penalty of \$25,000 or three times the amount lost on an annuity sale when a salesperson convinces an annuity holder to switch.

How did an industry with such a shameful track record manage to convince Congress to increase the sales of its product? Unfortunately the annuity industry gained credibility by convincing advocacy organizations representing women and minorities that annuities would keep these groups out of poverty. In addition, the annuitization option puts a spotlight on one of the more unfortunate feature of 401(k) plans, which is that unlike most defined benefit pensions, retirees can and often do take their payments as a lump sum—even before they've reached age 59 ½, when they incur taxes and penalties. With

no good advice, they might spend it foolishly rather than banking it and taking payments that will last a lifetime. Unfortunately, neither the advocacy organizations nor the bill's sponsors appear to have researched the track record of the industry before buying into the idea that an annuity is the solution to the problem.

For one thing, for the tiny percentage of 401(k) participants who have saved enough, there are other options besides annuities for providing income streams for life. For example, the mutual fund industry offers “managed payout” or “target distribution” funds. Along with featuring lower fees than their annuity counterparts, these funds permit investors to pass on the value of the annuity to heirs in the event the investor dies unexpectedly—as opposed to the annuity industry, which gets to keep the money in that scenario (unless the heir is a spouse.)

**Bottom line, however is that there is no investment that can turn a nearly empty nest egg into a full one.** My solution to the retirement crisis for America is to adopt the Australian system of mandatory 9% employer contributions, three times the current rate. If that's not feasible, at a minimum, we are obliged to tell 401(k) participants the “inconvenient truth” that they will probably need to work until age 75 to afford to retire because the 401(k) arrangement is currently not set up to provide a pension. We also need to tell them how much to save based on their investment time horizon, which the mutual funds managing 401(k) assets can't be bothered to do.

At the invitation of the U.S. Department of Labor, I offered recommended contribution rates for 401(k) participants based on the age when they join the plan to the ERISA Advisory Council in the fall of 2007. As a result of my testimony, the Working Group on Financial Literacy recommended that the DOL encourage communicating to participants how big a nest egg they need as a multiple of their salary at retirement.

Urgent reform is needed at a time when prospective retirees face higher costs than their parents, given the increased life expectancies —20 years versus 13 years when Social Security was established, along with increased healthcare costs due to growing obesity rates. At the same time, Americans are unlikely to meet these costs by relying on stock

market performance alone, given that the S&P 500 has performed almost as poorly during the first eight years of the 21<sup>st</sup> century than during the eight years following the Great Depression, with an average annual return of 1.1 percent compared to .9% from 1929 to 1936.

If the world's wealthiest nation is unwilling to make its defined contribution system act like a real pension unlike Denmark, Hungary, Poland, Slovak Republic and Mexico (yes, you read it right), at a minimum its leaders should communicate to their citizens the inconvenient truth that they will have to keep working until they can afford to retire.

**About Jane White:** Jane White is the founder and president of Retirement Solutions, LLC., which promotes 401(k) reform as well as providing investment education. White is also the author of the recently-released book, "America, Welcome to the Poorhouse," which describes the 401(k) savings crisis and was favorably reviewed by the *New York Times*, *Washington Post* and others. At the invitation of the U.S. Department of Labor, White offered recommended contribution rates for 401(k) participants based on the age when they join the plan to the ERISA Advisory Council in the fall of 2007. As a result of White's testimony, the Working Group on Financial Literacy recommended that the DOL encourage communicating to participants how big a nest egg they need to as a multiple of their salary at retirement.

White, who writes a column on the retirement crisis for *Employee Benefit News*, first observed the crisis in 1993 as an editor at Standard & Poor's Your Financial Future, distributed to half a million 401(k) participants at Fortune 500 firms. She also anticipated the housing bubble driven by the adjustable rate mortgage with her 1991 book, "The Cost-Conscious Homebuyer's Guide."

Previously White was a syndicated personal finance columnist for Gannett News Service and her articles have appeared in *The New York Times*, *Barron's*, *Investment News*, *Working Woman*, and *Newsday* and she has been interviewed on NN, CNBC and Fox Business News. White is also the author of "Employee Benefits for Small Business" (Simon & Schuster, 1991), and "A Few Good Women; Breaking the Barriers to Management" (Prentice Hall, 1990).

