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Perfect Your Portfolio: An Annuity Autopsy

Tax-deferred growth! Guaranteed income for life! An account that could grow if markets do well! Lose 15 pounds by eating ice cream!

It's not hard to see why annuities are gaining popularity, given the frequency with which their proponents make those claims (except that last one -- though if you know of a product that will do that, do tell). As we explained last month, "annuity" is a very general term applied to a range of financial products sold by insurance companies. The guarantees vary from product to product and from company to company. Last month, we explained the basic types of annuities. Now, we'll dig deep into the details of an actual, real-life annuity that you can buy right now (though you should definitely read what we have to say before you do).

There are a lot of details here, but that's the point: We want to emphasize that annuities have a lot of rules that you should know about before you purchase one. And as a bonus, when you're done, we'll give you a cookie.*

Till Death Does Your Income Part

We'd like to introduce you to a product you'll be getting to know quite well over the next few paragraphs: the MetLife Growth and Guaranteed Income Variable Annuity, offered through Fidelity Investments. You can buy it for yourself commission-free, or you and your spouse can own it jointly. At first glance, it seems to combine the best of all possible worlds. "Guaranteed income" means you'll receive a check in retirement no matter what happens to the markets. "Variable" means the money is invested in securities that have the potential to grow in value, which could lead to even more income. Plus, after an annuitant dies, whatever's left in the contract goes to the heirs. Sounds great, right? Well, let's take our scalpel to these benefits and see what they're made of.

Guaranteed income for life. This annuity has one of the "living benefits" features we explained last month. Specifically, this product offers what's known as a guaranteed lifetime withdrawal benefit (GLWB). After you invest your money, you can then withdraw a percentage of your "GWB Value" (MetLife left out the "L" in its acronym). In the first year, your GWB Value is the amount you invest.

The percentage you can withdraw depends on your age when you begin withdrawals (or, if you own it with your spouse, whoever's younger). For those ages 59 ½ to 64, the percentage is 4%. For those 65 to 75, it's 5%, and for those 76 or older, it's 6%. Once established, the withdrawal percentage doesn't change. So, for example, a 64-year-old would receive $4,000 in a year when the GWB Value is $100,000 (a 4% rate). Had she waited until she was 65 years old to begin withdrawals (assuming the GWB Value didn't change), she would have received $5,000 (a 5% rate). Every year thereafter, she will receive at least that amount ($4,000 if she was 64 when withdrawals began, $5,000 if she was 65) until she passes away. If this is a joint annuity, then the income continues until the second spouse joins the first in heaven's eternal honeymoon suite.

Potential for more income. Your money will be invested in just one fund: the **Fidelity VIP FundsManager 60% Portfolio**. The "60%" in the name indicates that it aims to have approximately 60% of its money in stocks. Investing in just one fund may seem like insufficient diversification, until you find out that the fund allocates its assets among approximately 75 other Fidelity funds. It currently has 45.8% of its assets in U.S. equities, 17.4% in international equities, 33.2% in bonds, and 3.6% in cash. Its return in 2008 was -26.9% (compared to -37.0% for the S&P 500), and in 2009 it returned 22.5% (the S&P 500 returned 26.5%). Basically, it's a safer, more conservative investment than an all-stock fund, and it has reasonable returns.

Now, here's where the potential for more income comes in, and where things get a little complicated. The money that goes into the fund is known as the "Contract Value," and at the time of purchase, it's the same as the GWB Value. However, the Contract Value fluctuates based on the fund's performance, and it is also reduced every year to cover expenses (more on that later) and withdrawals.

So let's say a retiree invests $100,000 into this annuity, and one year later -- after expenses and withdrawals -- the Contract Value grows to $105,000. The new GWB Value thus increases to $105,000, and that year's withdrawals will be 4%, 5%, or 6% of $105,000 (again, depending on the annuitant's age). If, on the other hand, the Contract Value had decreased (say, to $95,000), the GWB Value would have remained the same ($100,000 in this example), and that year's withdrawal would once again be $4,000, $5,000, or $6,000. This potential for a higher Contract Value continues every year until the annuitant (or older spouse, if jointly owned) reaches age 85. At that point, the annual income will continue, but the GWB Value is fixed.

Here Come the Costs

So how much do you have to pay for all these benefits? The insurance and administrative expenses for this annuity are 1.9% a year for single annuitants and 2.05% for joint annuitants. On top of that, you have to pay the 0.83% expense ratio of the Fidelity fund. None of these expenses are guaranteed to stay fixed, so they could be raised (or lowered, though of course that's not as likely).

Put it all together, and you're paying 2.74% to 2.89% a year for lifetime income that has the potential to increase. Is it worth it? Well, let's consider the likelihood that the Contract Value actually does increase. For that to happen, the return of the fund first has to overcome the cost of its expenses and withdrawals -- and that could be a tall order. Let's say that the Contract Value and the GWB Value start out as $100,000 at the beginning of a given year. Over the course of that year, the annuitant withdraws $5,000, while $2,740 (2.74%) is taken out for insurance, administrative, and investment expenses. That means the investments in the fund would have to grow by approximately 8% just to keep the Contract Value around $100,000, and even more for the Contract Value to materially exceed the GWB Value (which must happen for the annual guaranteed lifetime amount to increase).

The Fidelity VIP FundsManager 60% Portfolio doesn't have a long enough history to evaluate, but we can take a look at the **Fidelity Balanced Fund** (FBALX) to get an idea of what to expect from such an investment. The term "balanced" usually means a fund aims to maintain a 60% stock/40% bond portfolio, and Fidelity's is one of the best.

According to Morningstar, the Fidelity Balanced Fund has posted an average annual 8.14% return over the past 15 years, well above the 5.86% average return for similar funds. Still, we can see that if the next 15 years are anything like the last, it will be a challenge for the Fidelity VIP FundsManager 60% Portfolio to grow at a rate that will overcome the annuity's costs and grow the Contract Value on a consistent basis.

Of course, that's the 15-year average for balanced funds. One really good year could increase the Contract Value over the GWB Value, which would result in higher guaranteed income for the rest of the annuitants' lives. For example, investors who purchased this annuity at the beginning of 2009 -- when the investment returned 26% -- saw a big bump in their GWB Value after just one year. On the other hand, investors who bought the annuity at the beginning of 2008 and then saw the Contract Value plummet 26.93% may never see their income increase -- but it should be noted that they'll still get their last annual withdrawal amount for the rest of their lives. (This also illustrates why MetLife limits investors to this one fund. Its mix of stocks and bonds ensures that returns won't swing wildly one way or the other, limiting the insurer's risk.)

Lifetime Income With Liquidity

Last month, we discussed the immediate income annuity, which sends you a check every year for life. The catch is that when you die, the income stops, and your heirs get nothing (no matter what's left in your account). Also, if it turns out that you need slightly more income in retirement than the annuity provides, tough luck; you only get the annual amount to which you initially agreed.

With the MetLife Growth and Guaranteed Income Variable Annuity, however, you can withdraw more than the 4%, 5%, or 6% withdrawal rate -- but it'll cost you. If you take out more, it will reduce your Contract Value. Plus, those excess withdrawals will be assessed a "surrender charge" of 2% if taken within the first five years after purchasing the annuity. Still, if you need that extra money, it's available. Also, if there's any Contract Value remaining when you pass away, it will go to your heirs.

That makes this annuity much more appealing than an immediate income annuity, right? Well, not necessarily. Recall from last month that a 65-year-old male would receive $7,092 a year if he invested $100,000 in a Vanguard Lifetime Income immediate annuity; a 65-year-old female would receive $6,490. (Women receive a lower annual benefit because they are expected to live longer and thus receive income for a longer time.) Those benefits amount to 7.1% and 6.5%, respectively, of the investment, whereas a 65-year-old of either gender would be able to withdraw just 5% with the MetLife Growth and Guaranteed Income Variable Annuity. On the other hand, the MetLife annuity does offer the possibility of income growth, whereas the payout from the Vanguard Lifetime Income annuity will remain fixed. So which is more important to you: higher income or more liquidity (and the possibility of enriching heirs)?

So, Do I Need One?

The bottom line: The more your retirement will lack a guaranteed source of income, the more you should consider an annuity. This generally applies to retirees who won't receive a defined-benefit pension.

The Foolish Bottom Line

Believe it or not, there are plenty more details about this one annuity that we didn't have space to explore. To get all the facts, you need to read the 52-page prospectus for the annuity and the 16-page prospectus for the Fidelity fund. (If that sounds like a lot of reading, take a gander at the 252-page prospectus for the Prudential Premier Variable Annuity.)

If you take nothing else from this article, remember these two points:

1. Annuities can be very, very complicated. Do a lot of research before you buy one.
2. Annuities are insurance products, and as with all insurance products, you're paying someone else to assume your risk. The degree to which that makes financial sense varies from person to person. There is also a psychological benefit. Some people are willing to pay for that peace of mind, and only you can know if you are one of them.