What About Cheap Variable Annuities?

Paul, a frequent poster on the Bogleheads Forum, recently asked my opinion about Vanguard variable annuities (VA) for doctors and other highly paid professionals. As regular readers know, I generally recommend against mixing investing and insurance, as you usually end up with the worst of both. But the main argument against VAs is not that they are without advantages, but that the advantages cost way too much. By buying variable annuities through Vanguard, you can get them much cheaper. Perhaps then the advantages would be worthwhile enough to consider them in comparison to a mutual fund (MF) in a taxable account. Well, let's analyze this a bit.

There are two main advantages to consider with a VA. First, they grow in a tax-deferred manner. You pay no taxes on them at all until you pull the money out of the annuity. Second, in many states they are an asset that receives protection from creditors, unlike your taxable brokerage account in which you might hold a more traditional MF.

There are really three factors to consider in comparing low-cost mutual funds and a low-cost VA.

1 Cost of the VA versus the MF

While most VAs will cost you 2-3%, or even more, Vanguard offers annuities for a total expense of around 0.5%. That's still quite a bit more than most of its index funds with an ER of around 0.1% for the admiral versions, but at least they're

able to get close.

2 Tax-inefficiency of the Asset Class Held in the VA

The more tax-inefficient an asset class, such as nominal bonds, TIPS, or REITS, the more valuable the tax deferral available in the VA. Of course, when you pull the money out of a VA, all the gains are taxed as ordinary income, not at the more favorable capital gains rate. You also lose advantages of a taxable account such as a step-up in basis at death and the ability to tax-loss harvest.

3 Asset Protection Benefits of a VA

Every state is different, but in some states, (not mine), a VA is a retirement account and protected from creditors like an IRA or 401K. You never want the tax "tail" or the asset protection "tail" to wag the investment "dog", but there is a real value to asset protection for most lawsuit-weary physicians.

Making the Comparison

Let's first consider a tax-inefficient asset class, such as REITs. Let's make a few assumptions. Let's assume an 8% pre-expense and pre-tax return, which is composed 100% of fully taxable dividends. The Vanguard mutual fund (admiral shares) has an expense ratio (ER) of 0.1%. The Vanguard REIT VA has an expense ratio of 0.58%. Let's assume this physician investor is in the 28% federal bracket and the 5% state bracket and invests $10,000 per year and liquidates the investment without penalty at the end of the period specified.

After 1 year
Mutual Fund $10,529

Variable Annuity $10,497

After 10 years
Mutual Fund $134,239
Variable Annuity $134,434

After 30 years
Mutual Fund $794,698
Variable Annuity $832,448

This overstates the case for a REIT fund by a small amount, as some of those gains would be capital gains and taxed at a slightly lower rate in the mutual fund. It also ignores the benefits of more liquidity, tax-loss harvesting, and the step-up in basis at death. But as you can see, the benefit of the tax-deferral starts making up for the higher expenses and the higher tax rate at withdrawal of the VA after about 10 years. At 30 years, there is a clear advantage for this highly-tax-INefficient asset class, especially if you are benefiting from additional asset protection. (This all assumes, of course, that the decision is between a VA and a taxable account, NOT a 401K, IRA or other tax-protected account.)

What About A Tax Efficient Asset Class, like Stocks?

Next, let’s consider a very tax-efficient asset class held in a VA, such as the Vanguard Total Stock Market Fund. Again, we’ll make a few assumptions: An 8% pre-expense and pre-tax return, of which 2% comes from dividends taxed at 15% and 6% comes in the form of long-term capital gains, the same 33% marginal tax rate and the same $10,000 per year investment.

After 1 year
Mutual Fund $10,649
Variable Annuity $10,504

After 10 years
Mutual Fund $145,299
Variable Annuity $135,010

After 30 years
Mutual Fund $1,015,453
Variable Annuity $846,585

As you may notice, with a tax-efficient asset class, the VA never catches the MF. In fact, after 30 years, you've basically paid $169K for nothing but some asset protection. That seems pretty expensive to me.

Conclusion

Most investors, including high tax bracket investors like physicians, probably shouldn't invest in even the low-cost Vanguard variable annuities over a taxable account. However, an exception can be made if you value the asset protection benefits highly, don't have any room in your tax-protected accounts for a highly tax-inefficient asset class that you feel you really want to hold in your portfolio, don't mind the loss of liquidity, don't mind the loss of tax-loss harvesting ability, don't mind the loss of the step-up in basis at death, and you have a long investment horizon. Since most doctors aren't even maxing out their available retirement accounts, there's little reason for them to consider even inexpensive VAs.