Forbes

April 25, 2005

Excerpt from “**Costly Lessons**” (article attached below in its entirety)

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Costly Lesson

Some of the biggest names in insurance peddle lousy retirement plans with high fees and low returns. One and a half million teachers blithely signed up for these dogs—often with their unions’ blessing.

By NEIL WEINBERG

Teacher Michael Cangelosi wandered into the faculty lounge of his grade school in Derwood, Md. at lunchtime one day nine years ago, and a well-dressed man on the sofa beckoned to him with a plate of cookies and an offer of free advice.

The adviser was a salesman for AIG Valic, the largest vendor of retirement savings plans for teachers. He later whipped out colorful charts illustrating how Cangelosi, then in his mid-20s and with only a few thousand dollars saved, could avoid a trip to the poorhouse by setting up a tax-deferred teachers’ retirement plan. A brochure, listing some mutual funds, touted no initial sales commissions and fees as low as $3.75 a quarter.

Sold: In the next eight years Cangelosi put $14,200 into his retirement plan. Belatedly, last summer he addressed the question of whether he was doing as he hoped. By the time he bailed out and paid a $500 kill fee, he ended up with all of $13,655--$550 less than what he had invested over all those years. Why? One big reason was that he had been paying fees of 2% a year, two to three times the rate charged by big mutual funds. This during a time when a low-cost S&P Index fund would have returned 95%.

“It was a stinging feeling to realize that, for eight years, I could have been paying so much less for better investments,” says Cangelosi. He has since switched his faltering retirement plan to TIAA-CREF, the giant investment firm set up for educators--for what he says is only one-fifth the annual AIG fees.

Cangelosi was attracted by the idea of investing in mutual funds but in fact had been lured into buying an insurance plan that can best be described as a coals-to-Newcastle investment. The AIGValic agent had sold the teacher a variable annuity, a basket of half a dozen mutual funds wrapped in a life insurance policy.

This type of insurance doesn’t pay your surviving family a million-dollar jackpot if you die suddenly--it promises only to pay back the money you had put into it, plus any extra returns it earned. The main appeal of variable annuities is their tax deferral, yet Cangelosi already had that in his retirement plan. The main downside to annuities is stiff fees, often 2% or 3% a year. AIG Valic says it has revised its sales literature to more accurately portray the product.

Yet roughly 1.5 million teachers at the nation’s public schools have put their retirement savings into insurance plans, for a total $120 billion in assets. The business is stoked by some of the biggest names in insurance: AIG, the world’s largest insurer; ING; AXA; and MetLife. Some firms pay first-year commissions as high as 9% to agents, who troll school campuses for prospects.

“School districts don’t provide education [about retirement accounts],” says Daniel Otter, a teacher and operator of a Web site, 403bwise.com. “So the first time most teachers hear of them is when a salesman shows up in the lounge selling annuities larded with high fees and surrender charges."

Teachers unions are complicit partners in this dubious pursuit. Insurers cut murky deals with labor unions to buy exclusive access to their members, sometimes paying the unions millions of dollars in fees in exchange for the unions' endorsement of their annuity plans. Invariably this foists on teachers some of the most expensive annuity products around.

"Unions play a very large role in teachers' decision making," says Michael Beczkowski, a consultant with Bolton Partners who evaluates retirement plans for school districts. "Some companies offering these plans make large union donations, so it's very difficult to get rid of them even if their products are substandard. The participants pay for it."

The National Education Association, with 2.7 million members; the American Federation of Teachers, with 1.3 million people in its ranks; and New York State United Teachers, with half a million members, all endorse high-cost annuity products. The NEA won't disclose the fees it receives from its retirement savings provider, Security Benefit, a firm in Topeka, Kans. But one source says the fee was likely $3 million. The New York union gets $3 million a year from ING, which gets the shop's exclusive endorsement as a provider of annuities for New York teachers. AFT says it gets less than $100,000.

At the center of this thriving scheme is the inelegantly named 403(b), which, like the private sector's 401(k), takes its name from an IRS regulation. Both plans allow workers to invest for retirement free from taxes until the money is withdrawn. The key difference: Private employers have a legal duty to run 401(k)s in the interests of employees and spell out the terms; 403(b)s carry no such burden.

All told, 6.8 million educators and other nonprofit employees have almost $580 billion in assets in 403(b) plans. Some 80% of this is in fixed and variable annuities, and the business is growing 9% a year, says Spectrem Group, which consults to insurers. Universities make up just under half the total and take a more patriarchal approach, limiting their 403(b) offerings to a few low-cost, solidly performing vendors selling low-fee mutual funds. The well-regarded TIAA-CREF controls nearly half of universities' $250 billion in 403(b) assets.

Public school districts, by contrast, view 403(b) plans as an add-on to traditional pension plans, and typically they offer teachers zero guidance.

When teacher Douglas Taylor called the Los Angeles Unified School District looking for a low-cost 403(b) plan in 1997, the district couldn't even provide him with vendors' names. Taylor had to guess at them until he came up with an acceptable choice. Today the Los Angeles school system retirement plan, with 32,000 403(b) contributors, publishes a list of 112 different firms, most of them annuity vendors.

But hey, it's the law: California statute requires schools to give access to any retirement firm licensed to sell a product. With so much traffic in the lunchrooms, face time is the key to closing sales. And face time is expensive, a cost that mutual funds can't afford to cover if they want to keep their fees low. "If you're a company like TIAA-CREF with low costs and noncommission distribution, you really can't get any traction [in public schools]," says Richard Hiller, a vice president in the firm's institutional division.

Insurers and unions argue that, with 70% of teachers failing to save for retirement, they need a lot of handholding to get them started. Cheaper plans offer no adviser, and variable annuities are best for "people who are uncomfortable performing self-directed retirement planning," says an official at Security Benefit, which runs the NEA program.

Insurers insist their brochures disclose all costs, as legally required, and that their agents discuss the negatives in face-to-face meetings. "We're proud of the way we deliver products to that market," says Brian Comer, a senior vice president at ING. "We look at it as a question of needs versus the costs to provide for those needs."

Others counter that the shoddy sort of "financial planning" Michael Cangelosi received in Maryland is all too common. "Arguing it's better to have high-cost brokers than nobody is like saying Harlem is better off with drug dealers since there aren't enough pharmacies," says Edward Siedle, president of Benchmark Financial Services, which investigates money-management abuses on behalf of pension plans.

FORBES has written plenty about the many drawbacks of variable annuities, from "The Great Annuity Ripoff" in the Feb. 9, 1998 issue to "Annuity Gratuity" *(Feb. 19, 2001)* to "No Surrender" *(Nov. 29, 2004)*. Even the National Association of Securities Dealers says the insurance "may not be a good idea" in tax-sheltered accounts. "It will, however … generate fees and commissions for the broker or salesperson."

Some plans are horrendous. General American Life Insurance sells an annuity that hits teachers with a kill fee of 18% if they bail out in less than a year; lower "surrender fees" are charged even if an investor sticks around for 14 years. At PlanMember Services annual fees can run as high as 3.7%, plus $25. For one AIG Valic plan, only 3 of 16 actively managed equity funds have beaten their indexes over ten years or the life of the funds.

Occasionally insurers' sales pitches to teachers run afoul of the law. CGULife Insurance agreed to an $8.1 million 2002 settlement in a class action involving 14,000 Texas teachers. It also agreed to an injunction barring sales materials that don't clearly state that its reps are insurance agents and banning false statements that its products are endorsed by school districts, unions or others.

The NEA is a good example of how unions play the 403(b) game. It exclusively endorses a product labeled NEA Valuebuilder, sold by Security Benefit. The NEA says it selected the firm for "unsurpassed service coupled with innovative financial products."

One person familiar with the NEA's previous contract says insurer Nationwide paid the NEA $3 million annually until around 2000. The NEA then put the contract out for bid. One respondent, Great-West Life, offered an attractive option: no variable annuity, and a mutual-fund-only product with a slim 0.15% annual fee and no surrender charges. But Great-West was unwilling to pay the NEA for an endorsement. The NEA says it chose Security Benefit because its members want in-person consultation, while Great-West provided service by phone and Internet.

NEA Valuebuilder investors pay annual fees of up to 5.6% of their fund balance, including a "mortality and expense risk" charge of up to 0.9% (TIAA-CREF charges less than 0.1%) and mutual fund charges of up to 3%; cancel in the first year and you take a 7% hit.

To get independent agents to flog this dud, Security Benefit pays first-year commissions of up to 8%. That is in addition to overrides, expenses, bonuses and trailing commissions, not to mention "expense-paid due diligence trips and educational seminars." Security Benefit defrays the cost by itself taking kickbacks of up to 0.4% of assets from the mutual fund firms whose funds it offers to teachers. The good news: Only 60,000 NEA members own Valuebuilder, and 40,000 of them are in a mutual-fund-only product that spares them insurance fees.

ING also pays unions for endorsements and access. It runs a program for the American Federation of Teachers but pays that union only enough to cover related expenses. In a separate deal, ING pays the Oregon Education Association only $144,000 annually for an exclusive endorsement of its "tax-sheltered annuity" and the right to run "financial planning" seminars for members.

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Mutual back-scratching between insurers and unions is ubiquitous with 403(b)s, says Daniel Puplava, who sold the NEA's Valuebuilder in California when it was run by Nationwide. "When I did work at the union, I had to pay for tables, provide door prizes and dine labor people to market in their territory," he says. "I felt like a whore." These days he runs a 403(b) plan he devised for San Diego County's Office of Education. It charges a reasonable 0.3% administrative fee on top of fund fees and has no surrender charges or loads.

The WEA Trust, a unit of the Wisconsin Education Association Council, has shunned the standard model in which unions pawn off on their own members insurance salesman disguised as financial planners. The plan's six certified planners offer teachers retirement planning purely for a salary to avoid dispensing conflicted advice. The total cost to teachers of investing in mutual funds through the trust runs as low as 0.36% per year, or one-tenth that of the most expensive products on the market. Its fixed-return investment option is also paying a guaranteed 4.5% over the next year, at least 1.5 percentage points better than its closest rival, says Randolph Mullis, assistant executive director of the trust.

Teachers' advocates recently sponsored legislation in California aimed at forcing school districts to cap 403(b) fees. Insurers lobbied hard against them. Fliers anonymously appeared at schools comparing the proposal to limit high-cost choices to Hitler and the Holocaust. Web sites with addresses similar to 403bwise.com popped up to transport visitors to pro-insurer alternatives.

The proposal to limit sales of expensive 403(b)s was itself limited to improving disclosure. California now requires that vendors list plan basics on 403bcompare.com. That may help teachers protect themselves by doing their homework. Just like the rest of us.

Website: http://www.forbes.com/forbes/2005/0425/100_print.html