American Federation of Teachers - A Union of Professionals

Skip directly to:

- Content
- Navigation Block 1
- Navigation Block 2
- Search
- AFT Home

AFT - A Union of ProfessionalsTeachersHigher EducationPSRPPublic EmployeesHealthcareRetireesParents

Home > Publications > On Campus > 2000 > May-June > Special Report: Shark Attack!

Special Report: Shark Attack!

E-mail Print Bookmark

Investors in 403(b) plans, beware:
You are especially vulnerale to predators

Teachers, college professors and other education workers are being threatened by sharks--but not the kind that swim in the sea! These equally dangerous predators are "land sharks" who prey on unsuspecting or uneducated investors and devour their hard-earned retirement money. It's time we put a stop to them.

Under Internal Revenue Service Code section 403(b), employees of educational and charitable organizations are eligible to participate in pre-tax investment arrangements usually called tax-sheltered (or tax-deferred) annuities (TSAs or TDAs). These popular but little understood investments are used by an estimated three-fifths of public school employees and many college and university staffs to augment state or local defined-benefit retirement plans.

In many ways, TSAs resemble 401(k) plans that have become widespread during the past 10 to 15 years. The TSAs allow the participant to put money aside in a variety of investment vehicles before Uncle Sam gets his hands on any of it. The invested money grows tax free--until it is withdrawn through regular (annuitized) payments after retirement--although the amounts are subject to Social Security withholdings.

Sounds good. So, what's the problem?

The returns that participants realize on their investments are all too often way below returns on comparable investments in the marketplace. The reason is that many companies and salespeople in the business of selling financial instruments can think of countless ways to part investors from their money. These include high front-end costs, massive surrender charges, redemption fees, inappropriate

investment choices, sub-account fees, two-tier plans, big commissions and hidden charges for unneeded life insurance.

Unlike a standard employer-managed pension plan, in 403(b) plans the employer keeps an arm's-length relationship with the vendor. Because the employer typically does not contribute to the plan, schools and colleges neither recommend nor make judgments about which companies have access to the pre-tax payroll deductions that make TSAs work. There is no "plan document" to govern the employer's service arrangement with vendors. That means no federal paperwork, no fiduciary relationship and low administrative costs.

It also means no investor education.

For workers, it means that just about any insurance agent who can round up a minimum number of subscribers can hawk annuities or mutual funds. So, in Los Angeles, for example, more than 100 vendors create a bewildering array of investments and options to sift through. Financial products are pitched with dizzying variety in school lounges, cafeterias and in home visits by the sharks. Because there are so many different products to choose from, it is nearly impossible to become an educated consumer.

More than $422 billion is invested through 403(b) arrangements and, sadly, most of it sits in low-performing fixed annuity contracts, reports Spectrem Group/Access Research, a San Francisco-based consulting and research firm. Some 2 million public school teachers have more than $116 billion invested in 403(b) programs.

Only 15 percent of total TSA assets are invested in mutual funds. The big fund companies that fight tooth and nail for 401(k) investors generally cede the 403(b) market to insurance companies and their annuity products.

In spite of a roaring stock market that has run nearly unabated for more than five years, these TSA contracts may be netting less than the return on certificates of deposit. Over the work life of a typical participant, underperforming assets could cost hundreds of thousands of dollars in unrealized growth.

Agents whose companies have a computer slot for payroll deduction for TSAs in a school district or college are expert at promoting, explaining and selling their products. And certainly there is an allure to the idea that--in addition to a state retirement system and Social Security--for those who participate and qualify, a relatively painless investment each payday (unseen and before taxes) can grow to eye-popping numbers.

Once the hook is set, few participants monitor their statements or check the relative performance of their TSA against a benchmark such as the S&P 500 stock index or a corporate bond index.

What the law allows

Under the law, education employees can shelter up to $10,500 this year in a 403(b) plan with some limitations (you cannot exceed 25 percent of salary). Three broad categories of investments are allowed: annuity contracts, mutual fund custodial accounts, and life insurance contracts.

An **annuity contract** is an insurance company's written promise that, after retirement, it will pay a monthly amount to the participant no matter how long the person lives. These can be either "fixed" or "variable."

The problem with buying an annuity inside a tax-preferred investment vehicle like a 403(b) is that earnings on the annuity are already tax-sheltered. It's like buying an umbrella exclusively for indoor use.

In a **"fixed" annuity**, the contract has a guaranteed interest rate of usually no more than 3 percent or 4 percent. A $100 investment in a fixed annuity might be guaranteed to earn $3 or $4 over the year, but could earn $5 or $6 if market interest rates go up and the issuer elects to pass those rates on to the customer.

A **"variable" annuity** contract's cash value rises or falls depending on the performance of separate accounts that are invested in mutual funds. There is no guarantee that these "subaccounts" will meet their investment objective.

Mutual fund custodial accounts allow a participant to buy into a fund held by a bank or by (some) registered securities broker/dealers. Mutual funds are pools of assets (company stocks or corporate bonds, for example) managed with specific objectives in mind. Most readers are familiar with names such as Vanguard, Fidelity and T. Rowe Price, purveyors of a broad array of funds in the commercial marketplace.

A **life insurance contract** obligates the vendor to pay a specific sum of money when the insured person dies. There is no mystery here; life insurance is a common ingredient in nearly everyone's financial planning. Premiums are determined by the age and health of the insured. In a 403(b) plan, however, the life insurance component is called "incidental" and must meet complex rules and limits set by the IRS Code and by state insurance laws.

In many cases, the vendor can offer "multiple-choice" annuities. You can have a percentage of your deduction invested in a fixed contract and the rest in a variable product. This gives the participant a chance to practice what is known as "asset allocation," a way of tempering risk by investing both in conservative (fixed) and more aggressive (variable) components.

The costs

A teacher who invested in variable annuities during this decade--even if it was through high-priced mutual funds or annuity contracts--might not have noticed the exorbitant fees they were charged. The roaring bull market masked the high costs. But if we have another period like 1973 to 1983, fees could easily overwhelm any growth in the value of a TSA.

How costly can fees become? Here is an example borrowed from Steve Butler and cited in an article in the *New York Times*. A couple contributes $10,000 a year to a retirement program through equal deductions twice a month. If they earn 10 percent a year, after fees, they will have $641,000 after two decades. After three decades (through the magic of compounded interest) their portfolio will have grown to $1.9 million.

But if their annual fees are just *1 percent higher*, so they earn 9 percent on their investments, they will have *$75,000 less* after 20 years and *$355,000 less* after 30.

Annuities, the most common vehicle for 403(b) plans, come wrapped with a layer of insurance and extra fees.

Surrender fees, assessed if the annuity is sold within seven to 10 years after purchase, can be as high as 8 percent. Life insurance, covering only the amount invested (not growth on the investment) runs about 1.25 percent. Some insurers will guarantee a minimum amount of investment growth, but little more than can be realized in the most conservative investments.

The average 403(b) annuity charges administrative costs of 2.11 percent of assets a year, according to Morningstar Inc., a financial research firm. By comparison, the average mutual fund has expenses of 1.36 percent. Many large mutual funds, such as those offered by the Vanguard Group, have expenses as low as 0.18 percent of assets each year. Compounded over the span of one's career, this difference in fees means serious money.

Get out the shark repellent

The marketing of 403(b) products to school employees typically depends more on the one-on-one relationship between the sales agent and the prospective customer than it does on the investment's cost, expected returns or its features.

Many educators will acknowledge that they are novices at investing (never having had much money to invest) and that they need any help they can get. Vanguard and Fidelity won't send someone to sit across the kitchen table and hold their hands like insurance companies do.

That makes public school and college employees easy prey for the sharks who feed on these plans. Historically, it has been difficult for participants to get out of these low-performing annuities and into better mutual funds. Surrender fees are one part of the story, roadblocks put up by vendors are another.

Some school systems are revamping their 403(b) offerings. In Chicago, for instance, a new program is expected to save employees more than $6 million a year in fees. Before the change, according to a school official, teachers paid 2 percent to 3 percent in fees and more than two-thirds of their money was tied up in fixed investments. Now Chicago school workers can buy no-load funds and reduced-fee annuities through three companies.

The New York State United Teachers, Education Minnesota and the United Federation of Teachers (New York City) have also used their significant clout to force positive changes in the 403(b) options offered to their members and to reduce administrative expenses.

Stop the bleeding

So, you do your homework and find that you have a two-tier, fixed annuity that charges a surrender fee. Although it declines over the first seven years, it's renewed each time you make an investment (kind of a Catch 22 since you make investments every month). The rate of return is guaranteed at only

4 percent, and the cost of the life insurance component is eating up more than 40 percent of the guaranteed gain.

There are steps you can take to remedy a bad situation (see sidebar, "What you should know"). Employees need to act if their 403(b) options are turning them into shark bait.

Because most public employers do not screen vendors, a relatively small group of workers can petition for new and better choices in their TSA accounts. These may include some of the bigger mutual fund companies mentioned in this article, or others interested in doing business with your system.

The union can make this an issue in future negotiations. Contact your local, volunteer to be on a committee, investigate your options, make a presentation to the school board, write a column for the union's newsletter...raise hell. This is *your* money.

That's not to say it will be easy. Stephen Schullo, a Los Angeles teacher, is becoming something of a celebrity on this issue. He was horrified to discover the confusing, underachieving choices he and his colleagues faced in their 403(b) program. His tale has been reported in the *Los Angeles Times*, the *New York Times* and other publications.

Some insurance vendors and other providers are lowering fees or broadening investment options in the face of competition and employee complaints.

If you hold an annuity contract executed more than five years ago, it is likely you are paying too much. Seek out the agent who sold you the contract to see about converting it to another, better-performing, lower-priced option offered by the same company. If conversion isn't possible, find out about surrender charges. It may be better to pay a penalty than to continue suffering with an underperforming annuity. Consider getting out before you leave any more blood in the water.

Don Kuehn, a senior national representative and a trustee in the AFT employees' retirement plan, is the author of "Your Money," a regular column in this newspaper. John Abraham, AFT senior associate director of research, contributed to this article. This article is intended to increase knowledge and awareness of issues of interest to members and retirees. For specific advice relative to your personal situation, you should consult competent legal, tax or financial counsel.

people pictureNewsHot TopicsAFT Plus Member BenefitsSalary SurveysLegislative Action CenterPublications/Reports
American Academic

American Educator

American Teacher

AFT On Campus

PSRP Reporter

Public Employee Reporter

Healthwire

AFT's Closer Look

AFT Retiree E-news

Other Publications

Press CenterAFT Partnerspeople picture
HomeAbout AFTContact UsSite Map

Search:

AFT SearchAdvanced Search

What you should know

When considering investing in a 403(b) program, there are several points you should investigate. If you already are in a TSA, you'll want answers to these questions so you can evaluate your account.

Will I be penalized for pulling out my money?
This is probably the most important question you can ask. If there are surrender fees in the first five, seven or 10 years, you should know that. If the vendor does not allow "premature" withdrawals or transfers, you want to know that, too. What if you switch employers?

There are also things called "two-tier" annuities that charge huge penalties (up to 20 percent) if you take your money out in a lump sum rather than through annuitized payments. As a general rule, most advisors recommend avoiding two-tier accounts.

What kind of investment choices will I have?
The difference between fixed and variable annuities is explained in the main story. In variable annuities, the underlying portfolio is mutual funds. If you are talking to an insurance agent, these will probably be called "subaccounts." You'll want to know the performance record of these funds and the comparative record of the annuity. How does each stack up against a popular, easy-to-find benchmark or index?

What are the annual fees, and how are commissions being paid?
Here you want to know the sum of all annual fees. Those familiar with mutual fund investing may know that 12b(1) fees can be more corrosive to long-term investments than front-end loads. That's because the erosion of your earnings every year takes a greater toll than a single, larger, up-front fee. Same thing here. If the fees you'll pay each year are out of whack when compared to the typical mutual fund, stay away, you'll just be chum in the feeding frenzy of the sharks.

If you are buying from an insurance company, you need to know how the insurer is rated by the nationally known rating services: A.M. Best, Moody's, and Duff & Phelps. The security of your investment is no better than the strength of the underwriting company. If your insurer declares bankruptcy, what happens to your annuity?

people picture

American Federation of Teachers | 555 New Jersey Avenue NW Washington, DC 20001

© American Federation of Teachers, AFL-CIO. All rights reserved.
Photographs and illustrations, as well as text, cannot be used without permission from the AFT.

- Back to top