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Annuities: The Good, The Bad, and The Ugly

By John Hauserman, CFP®

Annuities can play a key role in a well thought out retirement plan; or annuities can be a very expensive investment product that is wrought with hidden fees, investment limitations and tax traps. Unfortunately for many, deciphering the difference can prove quite challenging. In an effort to better understand annuities and identify scenarios under which they may be appropriate, let's begin by dissecting that all-too-often confusing industry jargon.

I prefer to explain annuities by identifying the various divisions among them. The first and most obvious involves the timing of when an investor will begin to receive payments from the contract. The term *immediate* annuity simply refers to the fact that an investor will begin to receive some form of payment from the contract right away, usually within the first month. In contrast, a *deferred* annuity is a contract that is not expected to pay any income benefits in the near term, but rather is intended for use as a longer-term savings or investing vehicle. All annuities, no matter what other terms are used in conjunction, are *either* immediate or deferred annuities.

Immediate Annuities

Let's start with the immediate annuity because the terms, restrictions, and conditions associated with them are responsible for much of the misunderstandings regarding annuity contracts. In the case of the *immediate* annuity, an investor essentially turns over ownership of their investment to an insurance company in exchange for some manner of guaranteed income stream. Usually the guarantee includes a lifetime income payout, but it can be a shorter term. Generally the decision to invest in an immediate annuity is irrevocable (after the first ten days). The types and forms of guarantees can vary greatly, but there do exist some common features that can be found with a wide array of products. Some of the most common are as follows:

Single (Straight) Life Annuity: Provides payments for the life of the annuitant (person receiving benefits, who is most often the same person as the contract owner). All payments cease upon death.

Joint Life Annuity: Similar as above but will guarantee payments for the life of two individuals. Payments will typically be somewhat smaller than with the single life contract to offset the increased risk to the provider. Joint life annuities may provide as much as 100% payments to the survivor or lesser amounts (50% being common) as chosen at contract set up.

Refund Annuity: Provides a cash refund if annuitant dies before a predetermined period (10 years being common) or before the original investment amount is recouped. As with the joint option, the refund feature will reduce the amount of monthly payment made to the annuitant.

Period Certain Annuity: Provides payments for a specific period of time only. As with the refund option, a period certain feature is typically used in conjunction with a lifetime payout. For example, a single life annuity with a 10 year period certain feature would pay for the latter of the life of the annuitant or 10 years.

Deferred Annuities

A deferred annuity, on the other hand, does not typically offer the above options since no income payout is associated with the arrangement. The common feature of this contract form is the tax-deferred nature of the investment. It is important to note that while the growth that occurs in an annuity contract is tax–deferred, it is also taxed at normal income rates when withdrawn as opposed to the (currently) more favorable capital gains or dividend rates. (We will cover this in more depth later.) For most investors, the focus on *deferred* annuities rests more on the type of underlying investment rather than those payout options listed above.

Since deferred annuities are essentially long-term savings vehicles, the focus shifts largely to the method by which the contracts grow in value. There are basically three categories of deferred annuities and they are as follows: fixed, variable, and indexed.

Fixed Annuities: Investors who use fixed annuities enjoy the benefits of guaranteed interest *and* principal for the life of their contracts. It is important to note however, that the term *guarantee* is based solely on the claims-paying ability of the insurance company, and therefore their financial stability should be a significant factor to take into consideration. Because the insurance company is taking on the investment risk, they are not required to disclose fees and in fact are permitted to describe their offerings as having no fees. That does not mean that the insurance company earns no revenue off of your contract. The insurer invests collected premium dollars (your investment) in an underlying portfolio and obviously hopes to earn more than they pay out in promised interest. Contracts typically offer a guaranteed minimum interest rate as well as *extra interest* paid by the insurer when they experience favorable investment periods. The reason that *extra interest* is offered is to improve the competitive position of their products. Both guaranteed minimum interest rates and extra interest are governed largely by the prevailing bond markets. As a result, contracts written during periods of low interest (like we are currently experiencing) are unlikely to be as generous as ones written during more lucrative times. Be very careful about cashing in older policies. If you are considering doing so, make sure that you compare the minimum guaranteed interest rates of each. Many annuity providers complicate the comparison by offering temporary teaser rates that are attractive but disappear after a short period of time (usually one year). In recent years, many insurance companies have also begun to include *market value adjustment* (MVA) clauses to their contracts. Even though the account balance is guaranteed, an MVA can cause investors to lose money. Here’s how it works: If at the time that an investor surrenders their annuity the investment company has experienced a loss in their underlying investment portfolio, they can pass some of that loss onto the investor. This is a very important aspect to understand. While the MVA can work in an investor’s favor, it will generally do so only during periods of declining interest rates. Should we experience rising rates (as is widely expected), contracts with an MVA would likely be negatively impacted.

Variable Annuities: Unlike fixed annuities, variable annuities are sold by prospectus (a legal document describing terms and conditions, including costs and risks). An investor in a variable contract assumes the risk associated with investing in non-guaranteed products known as *variable sub-accounts*. The sub-accounts are often managed by name-brand mutual fund companies, although their cost structure (among other things) can differ greatly (more about this topic in the "ugly"). Because the insurer passes through the investment performance, they also are required to disclose their fees, which are generally significant. Most variable annuities offer a wide array of investment options, typically including stocks, bonds, and real estate from which the contract holder may allocate their funds. The account performance will depend solely upon the performance of these underlying accounts and therefore can increase or decrease significantly. A number of guarantees, known as riders, may be available at extra cost and can help to buffer potentially bad investment experiences. Some of the most common include:

1. ***Guaranteed death benefits*** typically assure that if the contract holder losses money due to investment performance and passes away, their heirs will receive at least the amount originally invested. Some riders also provide for periodic increases to the guaranteed death benefit amount. Those considering exchanging older contracts for newer ones should make certain that they are not inadvertently losing meaningful death benefits as a result.

2. ***Guaranteed withdrawal* riders** can make variable annuities function somewhat like the immediate annuities mentioned earlier. As a general rule, to access these features the contract holders agrees to abide by certain investment restrictions designed to protect the insurance company by limiting access to the riskiest of investment choices. Additionally, covered withdrawals usually can't begin prior to age 60 and must not exceed 4-5% of the protected value. (Exact terms are defined in the prospectus.) Under the rider, should the withdrawals and market conditions cause the account value to hit zero, the insurer will continue to make payments to the contract holder (insured) for the remainder of life. Many contracts also provide opportunity for the income stream described above to grow. Typically, in those years that the insured does not take out any money, the insurer will automatically increase the future guaranteed payments. A word of caution applies here since this concept is often used by unscrupulous sales folks to skew the perception of their products—more about that in the "*bad.*"

3. ***Nursing home* riders**, as the name implies, offer protection in the event that the contract holder finds themselves in need of qualifying care. A common example includes contracts that offer to pay some multiple of premium to cover potential nursing home costs. For example, if an insured deposits $100,000 into a contract and waits the required number of years, the insurance company agrees to pay something like $300,000 over a five- or six-year period. Once again, terms and costs vary by company and can be found in the prospectus. Bear in mind, however, many such riders will require that the policy holder go through medical underwriting before being accepted.

Index annuities: Theses are in many ways even more complicated than either of the above types. In my opinion, index annuities represent a hybrid between fixed and variable. Like a fixed annuity, the insurance company guarantees your principal and therefore is under no requirement to disclose their fees. Like a variable annuity, the investment experience of the policy holder will vary depending on the performance of financial markets. Perhaps the most common such investment option is the S&P 500 indexed annuity, which ties returns to the ups (but not the downs, since the account principal is guaranteed) of the hypothetical blue-chip bellwether. In reality, most accounts offer a number of different investment strategies, including stocks, bonds, and fixed interest. That is the simple view; actually the devil is in the details. To understand those details we must introduce a whole additional set of terms:

Caps: While linked to the performance of various investment markets, index annuity accounts are subject to performance caps. For example, while the S&P 500 posted very strong returns of 29% in 2013, most indexed annuities had their gains capped at less than 6%. In other words, they did not achieve anywhere near the returns of the market they set to mimic. Now to be fair, unlike the stock market, the principal investment amount in the annuity accounts were guaranteed not to lose value. This might not seem too impressive when compared to the stellar results of the S&P 500 last year, but it sure was comforting in 2008 when that same index suffered crushing results.

Participation rates: Along with being capped, or instead of being capped, the returns of some indexed annuities are also subject to being pared by what is called the participation rate. For example, an S&P 500-linked annuity with no cap, but having a 50% *participation rate*, would have posted exactly half of the gains of last year's whopping results.

Point-to-point: When determining the performance of index annuity accounts, there are two primary methods on which to base the above mentioned caps and participation rates. The point-to-point method is probably the most common and is certainly the easiest to understand. A common application of this method involves simply noting the value of the targeted market (I have been using the S&P 500 in my examples) on the original day that the annuity is purchased and then comparing that to the ending value (usually a year or so in the future). If the value is higher you get a gain subject to caps and/or participation rates. If the value is lower, you get neither a gain nor a loss. No loss occurs since your principal is protected by the insurer.

Averaging: Yet another method to determine loss or gain for a contract year involves averaging. This strategy systematically measures periodic performance on a much shorter basis and then averages the values together to arrive at the returns for the year. A common example is monthly averaging in which the monthly returns for the underlying markets are noted and then averaged together at year's end. In my experience, monthly averaging will, over time, result in meaningfully lower returns than the simple point-to-point method.

In my opinion, averaging will result in meaningfully lower returns over most time periods. The newer method known as monthly capping does not appear to prove any exception.

The Good

So, are annuities bad? Well that depends on what the investor is looking for. Annuities are certainly complicated, often sold deceptively, and commonly laden with fees and gimmicks. However, they do provide guarantees that can be very appropriate for the right investor. In reviewing my own business practice, I have recommended annuities to about 25% of my clients. In so doing, I look for two fact patterns. Annuities typically appeal to risk-averse investors—in other words, those who might otherwise be only suited to CDs and money market accounts. Unfortunately, not all investors can afford to retire on the paltry returns offered by those investments. This brings us to our second fact pattern. Being a risk-averse investor is not by itself a problem unless the low returns are likely to result in a planning risk. Simply stated, if a 60-year-old investor has $1 million, needs $45,000 a year to live on, and is earning 0.24% in a money market account, he or she is in danger of outliving the money. While expensive and complicated, the right annuity may provide a solution through guaranteed income that can't be outlived. In this way annuities can be quite good.

The Ugly

The ugly (yes, I changed the order) involves the myriad of hidden fees, costs, and restrictions that accompany annuities. Take a look at some of the most common costs associated with annuity products:

M&E: Mortality and expense charges by the insurance company cover their costs and risks as well as provide for profit. M&E charges are based on the account value and often run between 1-2%.

Rider fees: Certain additional risks carried by the insurer result in additional charges known as rider charges. As a general rule, any meaningful benefit offered by the insurer increases their risk and your costs. Rider fees can be meaningful and often run between 1-2% (in addition to M&E).

Sub-account charges: The sub-accounts that are found within variable annuities commonly represent additional costs to the investor. For example, if a contract has the XYZ Growth Fund as a *sub account* (let's assume that XYZ also runs a well-known mutual fund that normally charges a 1% management fee), it is likely that as a *sub-account* found in a variable annuity it is layered with additional costs. In this case the management fee might be 1.5%, with the additional .5% going to the insurance company's bottom line.

Withdraw penalties: While few annuities have up-front sales charges, most have early withdrawal penalties that can be very significant. The worst examples tend to be the index annuities, which can come with 20% penalties that don't go away for 20 years! Be careful.

IRS penalty: Early withdrawals prior to age 59.5 are subject to government penalties assessed only on the gains.

Tax trap: While annuities are known for their tax-deferred qualities, a little considered fact about the contracts involves their tax treatment at death. Upon death of the owner, taxes on the gains are levied at normal income tax rates. This is important for those who are primarily concerned about estate planning, since other types of assets may have much more favorable tax treatment. For more details please consult a tax adviser.

The Bad

The word *bad* references a quality of character and unfortunately it seems that annuities bring out some pretty

bad characters. I am referencing the often deceptive sales practices that are being used by the unscrupulous to lure the vulnerable. Let's examine a sales pitch recently heard in a radio advertisement, which went something like this:
Folks, the S&P did nearly 30% last year and where were you? Did you miss out? Do you want to get back in and experience those gains? Let the pros at _ _ _ _ show you how to get those gains but not lose any money if the market goes backwards like it did in 2008. Not only that, but you can get a premium bonus of 7% just for signing up. That's free money; don't let it go to waste. That's not all, the pros at _ _ _ _ will also guarantee 6% growth of your income.
This was an ad for an index annuity; let's take a closer look at this monstrously deceptive pitch. First, as mentioned earlier, nobody that owned these contracts got anywhere near 30% last year due to the caps and participation rates. Most got something less than 6 or 7% and newer contracts less than that even. It is true, however, that these accounts don't lose money even when the stock market goes backward. Next we get to the "so called" premium bonus. This is total smoke and mirrors since contracts that offer premium bonuses pay less interest (to the investor) than those that offer no bonus. Here is a common example: A company offers a contract with a 5% cap that locks up your money (via withdrawal penalty) for seven years. The company also offers a contract with a 7% premium bonus, meaning that if you deposit $100,000 they will add $7,000 to the account. What they don't mention is that the penalty period increases to 18 years and during that time the cap rate is reduced to 4.5%. If you do the math it ends up costing the investor to get the bonus. This is a hypothetical example to make the point, but it illustrates a real life scenario that proves a more accurate take on bonus contracts. Lastly, we get to the granddaddy whopper of them all: the guaranteed growth *of your income*.

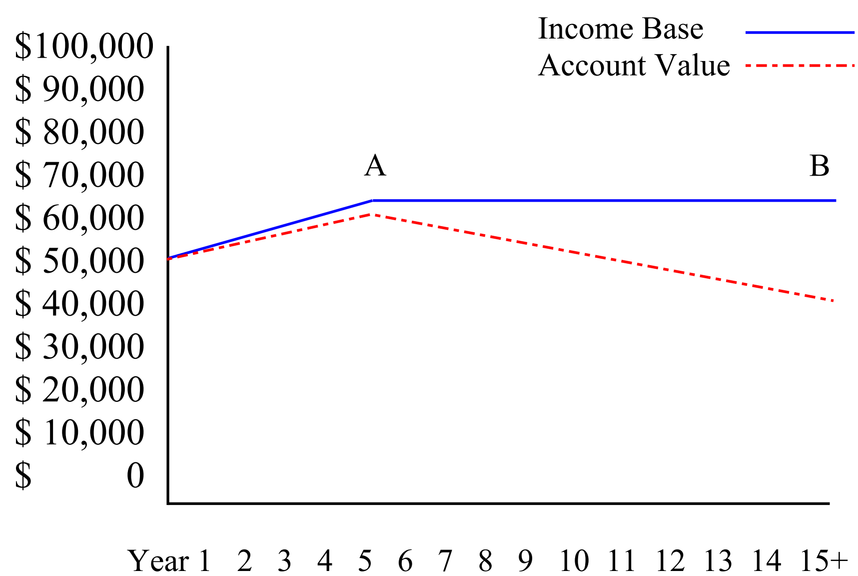
Most reasonable people would assume that if you deposited $100,000 and got 6% guaranteed growth that at year end you would have $106,000—not so. The last time I checked one of these contracts the cap was 3.45%, meaning that the most an investor could possibly have was $103,450. So why is this not a lie and why aren't people going to jail for fraud? This can be answered by insertion of the phrase *of your income*. What is guaranteed is not growth of your money, which we were intentionally led to assume, but rather growth of a formula that allows you to take out your own money. What the pitch is referring to is the guaranteed withdrawal rider in which the contract owner is allowed to take 4 or 5% of their account value guaranteed for life. It is important to be aware that it is the *withdraw for life* that is guaranteed, not the *account value*. Here's how it works: If an investor deposits $100,000 the rider might guarantee that they can withdraw $5,000 (or 5%) of their original amount. If the market does terribly and the account value goes to zero the account holder will still receive the $5,000 annually for life. The guaranteed growth of income rider has no impact on the account value. It simply states that if the

> Annuities that offer premium bonuses pay less interest (to the investor) than those which offer no such bonus.

account holder takes no money from the account then they will be guaranteed to be able to take 5% of $106,000 (a hypothetical amount called the income base) in year two. Please keep in mind that most of these contracts actually received about 3.45% last year so the actual account value is only $103,450. That's right. Under current cap rates most of the contracts will eventually cannibalize themselves since they are allowing withdraws that exceed the allowable growth rates. How does the insurance company afford this? Simple: by offering the feature only to senior citizens they can be assured that the policy holder is unlikely to outlive the slowly eroding contract. Does this make them junk? It probably does if you believe the sales pitch and think that you are getting guaranteed growth equal to that of the stock market with 6 or 7% guarantees. However, if you are comparing it to today's CD rates in which a 5% draw rate will likely cannibalize the account even faster, then you may find a favorable comparison.

For a detailed pro/con review of common investment products,visit RetirementQuest.com and check out the "Tool Box" link (found on the Resources tab).

Illustration of Account Value Versus Income Base



In this typical example of current index annuity rates and features, the guaranteed income base increases by 6% a year (during years with no withdrawals), but the actual account value is capped at just a 3.5% annual increase, meaning 3.5% is the best an investor could hope for and would require ideal market conditions throughout (an unlikely event over extended time periods). Point A represents the year in which withdrawals begin. Point B illustrates the possible difference between the guaranteed income base and the actual cash value that an investor could get their hands on if needed.