Wealth Strategies

Annuities – Caveat Emptor – Buyer Beware

Part 11 of 12
Annuities – Caveat Emptor – Buyer Beware

Although there are many financial advisors that consider annuity vehicles suitable for certain investors in certain circumstances, annuities are almost never the right investment solution. This is especially true regarding variable and equity indexed annuities, which grew dramatically in popularity after the 2008 “Great Recession” and offered most buyers a very poor deal in many ways. In addition to the complexity and details surrounding annuity products and given that most financial advisors don’t even truly understand all the nuances of the products they pitch, the biggest concern is that investors are being given a false impression that they are receiving something for nothing. This article will breakdown and demonstrate that most annuities are excessively complex, highly illiquid, far more expensive than anyone might fathom and often far riskier than investors realize. Annuities should remind us of an old adage that goes, “if it sounds too good to be true, then it most likely is.”

The basics - What is an Annuity and what am I actually buying?

An annuity is a contract between you and an insurance company in which you make a lump sum payment or series of payments and in return obtain regular disbursements beginning either immediately or at some point in the future. Beyond that definition, however, it can get very complicated.

The Goal of Annuities:

The stated goal of annuities is to provide a steady stream of income during retirement so as to insure against the risk of outliving one’s income stream during their golden years.

Types of Annuities:

All annuities fall into one of two broad categories, depending on when you start receiving income. Most deferred annuities will annuitize – that is, begin paying you a lifetime income stream - at age 90 by contract, although you can annuitize sooner if you wish. Deferred annuities are also considered a type of long-term personal retirement account, which allows you to save and invest on a tax-deferred basis with an option to receive a stream of income at a later date. The other is an immediate annuity, which provides regular income payments right away or within a short time afterward.

1. Deferred Annuity:

• **Fixed annuity:** Fixed annuities are generally considered a conservative investment, meaning they carry little risk. This makes them particularly attractive to retirees. Fixed annuities have characteristics similar to those of a certificate of deposit (CD) with a bank, although the terms are typically longer. In essence, insurance companies guarantee a fixed interest rate for a certain period of time. At the end of this period, the company will declare a renewal interest rate and another guarantee period. Most guarantee a minimum interest rate for the life of the contract.

• **Variable annuity:** For investors who
want access to more investment options, variable annuities offer “sub-accounts,” which look like mutual funds inside of an insurance policy. Variable annuities have characteristics similar to those of a mutual fund or mutual fund portfolio.

• **Equity index annuity:** This annuity is a blend between a fixed and a variable annuity, where the insurance company invests in a mix of bonds and stocks designed to return a targeted percentage of a particular index (e.g., S&P 500). The owner does not control the investment selection but can participate to a degree in stock market gains during a rising market. Conversely, if markets fall, the contract guarantees a minimum return, typically three percent.

2. **Immediate Annuity:** Immediate annuities can provide a fixed or variable stream of income from an insurance company, depending on the type of immediate annuity you buy. In an immediate annuity, payments begin immediately or within one year of the policy’s issue. These contracts are also referred to as “single premium immediate annuities” or SPIAs because they are usually purchased with a single deposit. SPIAs can help you manage the risk of outliving your money, which is known as “longevity risk.” More specifics on SPIAs at the end of this article.

**Unwrapping Annuity Myths**

Since 2008 when the Great Recession hit and the stock market dropped precipitously scaring investors alike, variable annuities sales soared as they were promoted as guarantors of your money. With variable annuities, it was claimed that you could once again invest in the stock market without fear and your money (amount invested) would be protected for nominal insurance fees. During the past decade or so, annuities wrapped within tax-deferred income riders have come to the forefront as salesman began pitching them with a “guaranteed yield” that was several percentage points higher than the Treasury, without jeopardizing principal.

Unfortunately, well-meaning or not, annuities have been and are being sold to the public improperly as there is indeed a high price to pay. Two of the most over-hyped myths or claims that insurance salespeople are utilizing to pray on feared investors include the following:

**Claim #1: “Annuities Guarantee Principal,”**

A primary selling point of many variable annuities is the ability to pay a fee for receiving living benefit riders which claim to guarantee income, principal or the ability to take withdrawals over the contract holder’s lifetime. However, many benefit riders are only useful if your annuity performs relatively poorly and some require you to convert the annuity into a stream of payments (annuitization) which is typically an irrevocable solution. Three of the most common riders that annuities provide are:

1. **Guaranteed Minimum Withdrawal**
Benefit Rider (GMWB):
The annuity provider guarantees a minimum income stream (usually monthly, quarterly or annually), but only over a predetermined period, typically over the contract’s term or until the total amount paid equals the principal amount.

2. Guaranteed Lifetime Withdrawal Benefit Rider (GLWB):
This rider also provides a guaranteed income stream, typically a percentage of the principal, but lasts your entire life even if your principal would have otherwise depleted.

This rider also provides a guaranteed income stream that lasts your entire life but the principal balance is usually forfeited after a set maturity period.

The Problem with Income Riders:
The main intent of riders was protection (principal guarantee) against another investment year like 2008. Scared investors wanted to make sure their income stream would continue. Sales people prayed off investor trepidations by making riders an easy add-on sale to the annuity itself. Unfortunately, many riders have strict conditions, features, and requirements. What promoters of annuities don’t tell you or talk about is:

- **Income riders are not guaranteed yield:** Payouts from income riders are not strictly yield. This is a separate calculation on an annuity and is an attached benefit that you have to pay for the life of the annuity. The income rider is independent of how the principal performs and you cannot peel off the interest.

- **Income riders cost** on average between 1.00% - 1.50%; they are not free! When combined with other fees (which we will discuss later), investors could be looking at paying between 2 - 4% in aggregate on an annual basis. For any benefit that may have been present, it is eliminated by the high cost of fees.

- **Income riders do not adjust for inflation** or for cost-of-living expenses.

- **Annuitzing:** This is converting the deposited funds into periodic payments. When you annuitize the contract, you typically turn the entire principal over to the annuity provider. This decision is usually irrevocable. In essence, you lose control of your money.

- **Waiting period:** Many riders require a waiting period before you can withdraw and receive the full guaranteed benefits. This waiting period is separate from the period where you may incur surrender fees for withdrawing funds. Some waiting periods can be as long as 10 years, so if there’s any chance you will need this benefit sooner, be sure you understand the contract conditions.
• **Limited Investment Options:** Investors typically don’t have free reign on how to allocate their investments within the contract when utilizing most living benefit riders. Recent bear markets have caused some insurance firms to limit the growth of living benefit rider benefits by reducing equity exposure within an annuity. This prevents the income benefit from rising rapidly and causing a liability for the insurance firm. It also means many investors may receive a reduced benefit from the guarantee they are paying for.

2. **Today’s investment environment has a lower expected return over at least the intermediate term environment,** which limits the potential for upside in the first place. If the retiree is taking out 5% annual withdrawals and dragging a 2 or 4% total expense for the cost of guarantees, plus the cost of the annuity itself, it may be almost impossible for growth to exceed the drag of withdrawals and costs before reaching the point of inevitable depletion.

**Equity Index Annuities - The Ultimate Rider on Steroids**

Given the pain that the last bear market brought to insurance companies (providing retirement income guarantees) many guarantees have shifted to contracts where the annuity company itself has gained ever more control of your money. Even though they have been around for 20 years or so this control has come in the form of **Equity-Indexed Annuities (EIA)** as they are being sold to the public in the name of smoothing out market volatility.

In its simplest form, EIAs have minimums and maximums based on performance. A performance “floor” provides a minimum level of return you can earn while a performance “cap” sets a maximum return, usually either monthly or annually. Participation rates are another type of cap. They determine what share of the market’s return you can get. For example, if the market were to rise 10% but your participation rate was 80%, your total return would only be 8%. From a marketing perspective, the smoothing out of market volatility sounds like a great deal for investors.

“The pure psychology of downside protection with upside potential sell really well”.

Simply put, floors are meant to protect investors from losing too much when the market is down a lot, while caps are meant to protect insurance companies...
from paying out too much when the market is up a lot. Unfortunately, while it sounds like “caps” and “floors” might lead to steadier returns over time, nobody even talks about the possibility of actually losing money with an EIA. For example, many insurance companies only guarantee that you will receive 87.5% of premiums you paid plus 1-3% interest. Therefore, if you were not to receive any index-linked interest, you could lose money on your investment. One way in which interest earnings can evaporate is if the index linked to your annuity actually declines.

Unfortunately and in many respects, EIAs have actually evolved in ways to protect the benefit of the company more than the client they represent. Simply put, the upside for insurance companies using equity-indexed annuities is that it’s far easier to manage the costs of the guarantee rider when the company controls all the money that underlies the guarantee. That being said, the company has the flexibility to set participation rates, cap rates, and spreads at levels that ensure the product will be viable.

In the final analysis, the investor really is not better off with an EIA as opposed to a traditional brokerage account. Below is a graph illustrating performance returns of an equity index annuity vs. various alternative investments. The graph showcases an equity indexed annuity against the S&P 500 Index, a typical equity index fund and a domestic bond fund. The results were not surprising as the EIA’s value with all its expenses and costs was less than half the value of a simple equity index fund. These performance returns should leave no doubt in one’s mind that a stock index fund that is left with enough time should far-outperform in value the need for an annuity and all its bells and whistles (i.e. insurance riders).

Claim #2: “Annuities are tax-deferred and therefore extremely tax-efficient.”

This claim has been around for a long time so let’s set the record straight. There is an element of truth to this statement that annuities are tax-efficient. The interest, dividends and capital gains within the annuity are tax-deferred, but when the money is eventually distributed, you get whacked with taxes. So let’s make no mistake about it, the tax-deferral of annuities is worth something, but there’s a price - or prices, really - to be paid.

For example, when you start withdrawing money from an annuity, earnings (but not principal) will be taxed at your ordinary income rate, rather than at the lower capital gains rates applied to investments in stocks, bonds, mutual funds or other non-tax-deferred vehicles in which funds are held for more than one year. Investing in a tax-deferred annuity means that you may be converting capital gains into ordinary income, which can add up to big tax payments, especially for those in high tax brackets during retirement.
essence, you are trading the tax privilege of capital gains for a rate that could be twice as much.

Don’t forget that tax-deferral comes with another downside risk in that there is a 10% penalty for withdrawals before age 59 ½ in retirement or non-retirement annuities. That could be a problem if you need the money in an emergency, decide to invest in something else, or want to retire early.

What about putting qualified retirement money (IRA) into an annuity?
Incredibly, many financial advisers and insurance agents recommend variable or equity-index annuities for accounts that are already tax-deferred, like 401(k)s, 403(b)s and IRAs. There are two very strong arguments against putting your IRA money into an annuity.

1. Both IRAs and annuities are tax-deferral mechanisms. If you are already deferring taxation by setting up an IRA, you gain no further tax advantage from investing in an annuity.

2. Second, with annuities, you are required to pay a mortality and expense fee (generally 1% of your investment) along with an annual contract fee. These fees are on top of any custodial fees that you may be paying for your IRA itself. The result is that this combination of fees may eat into the growth of your investment over time. We will talk more about fees in the next section.

Utilizing an annuitized annuity in qualified accounts makes absolutely no sense because these accounts are already tax-advantaged. If someone tries to sell you a variable annuity to hold in a qualified tax-deferred account like an IRA, 403(b) or 401(k), head for the exits. Even after unwrapping the truth about annuity myths, we are not finished with all the negatives involved in this story. We still need to discuss the costs and exorbitant fees of annuities:

Annuity expenses and their overall cost

“Annuities are a secure method of providing retirement income but that level of security comes at a really high price, particularly with current market conditions”

While you don’t have to be an expert on all annuity fees, knowing the most common types will help you evaluate products and ask the right questions. Different types of annuities – whether variable or fixed, income or deferred – charge different types of fees (see the chart below). Generally, variable annuities charge explicit fees, while fixed annuities tend to embed their costs in the interest rate or income payout amount. Indexed annuities take a different approach by limiting returns through factors such as participation rates, spreads, and caps.

Generally, there are four types of annuity fees that comprise these products and need to be understood:
1. **Insurance charges.** Also known as mortality and expense (M&E) fees and administrative fees, these charges pay for insurance guarantees that are automatically included in the annuity, and the selling and administrative expenses of the contract.

2. **Surrender charges.** Most insurance companies limit the amount of withdrawals one can take during the initial years of a contract, and place a surrender charge on any withdrawals above that preset limit (typically, to help cover the commissions the company paid). Be careful, as surrender charges can be significant and can be imposed for an extended time period. Be sure to ask for details on any surrender charges to help ensure that you have enough flexibility.

3. **Investment management fees.** These are assessed depending on the investment options within variable annuities, and are similar to management fees on mutual funds. Check the annuity prospectus for any underlying funds to learn how much you might pay for investment management fees.

4. **Rider charges.** Riders are optional guarantees available in some annuities. As mentioned earlier, there is typically an additional cost to purchase a rider in an annuity.

As you can imagine most annuity fee structures are quite complicated and do not have a single flat fee rate. Many annuities have several layers of fees that, together, can add up to several percent and thousands of dollars annually. The chart below highlights and summarizes the hypothetical impact on a $100,000 investment in a variable annuity.

Over time, the few thousand dollars paid in fees each year can add up significantly, making it difficult to reach your goals. Other investments may provide a less costly way to accomplish the same objectives.

**Note:** One caveat regarding surrender fees that you should be aware of: Annuities with longer surrender periods typically fetch higher brokerage commissions. According to a joint report by the U.S. Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD), “High commissions, typically above 5% for variable annuities, help drive sales of these products.” The SEC states, “Regardless of how much you trust your financial professional, it is always legitimate to ask how-and-how much-he or she receives for selling a particular product over another. If an advisor receives a high commission for any product, your best interest and financial needs may not be their sole motivation for selling it to you.

<table>
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<th>Variable Annuity Expense Description</th>
<th>Hypothetical</th>
<th>Annual Cost</th>
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<tr>
<td>Mortality &amp; Expense Risk</td>
<td>1.18%</td>
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<tr>
<td>Administrative Fees</td>
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<td>Optional Guaranteed Minimum Death Benefit Rider</td>
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<td>Optional Guaranteed Lifetime Withdrawal Benefit Rider</td>
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<tr>
<td>Fund Expense for Underlying Funds in Variable Annuity</td>
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<tr>
<td><strong>Total Cost</strong></td>
<td><strong>3.95%</strong></td>
<td><strong>$3,950</strong></td>
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How do ongoing fees affect your investment portfolio?
As illustrated below, ongoing fees can dramatically reduce the value of your investment portfolio. This is particularly true over time, because not only is your investment balance reduced by the fee, but you also lose any return you would have earned on that fee. Over time, even ongoing fees that are small can have a big impact on your investment portfolio.

This chart illustrates the effect of different ongoing fees on a $100,000 investment portfolio with a 4% annual return over 20 years. As the investment portfolio grows over time, so does the total amount of fees you pay. Because of the fees paid, you have a smaller amount invested that is earning a return. Although this graph illustrates an annual annuity fee of 1%, imagine an annuity with all the bells and whistles attached to the riders. The lost earnings due to exorbitant fees would be extraordinary.

Source: http://www.sec.gov/investor/alerts/ib_fees_expenses.pdf

Other reasons to avoid annuities:
If false insinuations and exorbitant fees are not enough to have you completely running for the exit doors, then how about a few more poignant facts as to why annuities are not in your best interest.

Taxation upon Death (No Step-Up in Basis)
Upon your death, the person inheriting the annuity must pay income tax on any gain at their ordinary income tax rates. If they cash in an annuity with a large gain, it may push them into a higher tax bracket. Thus, from an estate planning perspective, proceeds from most deferred annuities do not receive a “step-up” in cost basis when the owner dies. Other types of investments, such as stocks, bonds and mutual funds, do provide a step up in tax basis upon the owner’s death, which can limit the tax liability for your heirs.

Example: If you invest $100,000 in stocks then pass away when they are worth $120,000, the $20,000 gain is income-tax-free to your heirs. The same stocks owned via an annuity throw $20,000 of ordinary income onto your heirs’ return.

In 20 years, the total amount paid for a 1% annual fee adds up to almost $28,000 for a $100,000 initial investment.

In addition, if you were able to invest that $28,000, you would have earned an additional $12,000.

- additional return if the fees paid were invested
- total amount paid for the 1% annual fee
- 4% annual return less 1% annual fee
Liquidity Problems
First, if you try to take out the money inside an annuity before you are 59½ years of age, you will owe a penalty tax on any gains. If you cash in too early (say, within seven years) you’ll probably additionally owe the vendor a surrender penalty. Stocks held in a brokerage account have neither of these problems.

Second, because actuaries need time to make assumptions workable and insurance companies need time to recoup the larger-than-average commissions to agents, most annuities tie your hands with surrender charges—a meaningful reduction in your payout that usually descends over five, seven or even up to 15 years.

Finally, since you’re paying for tax-deferral by taking a tax hit upon distribution, many investors are afraid to take the money out, especially since annuities are taxed on a Last In First Out basis, which means that the gains (100 percent taxable) are distributed before the tax-free principal.

Complex Nature & Disclosure Issues
The complexity surrounding annuity products, especially variable annuities, combined with lucrative incentives to financial advisors who sell them have left many clients with expensive investments that they far too often do not understand.

Is there any annuity that might make sense?
The answer to that question is equivalent to finding the cleanest dirty shirt in the laundry basket and in this particular case that would be a Single Premium Immediate Annuity (SPIA).

What is a SPIA?
A SPIA is a single premium immediate annuity issued by an insurance company allowing a person to turn a lump sum of money into a regular payment that is guaranteed for a certain period. A Single Premium Immediate Annuity (SPIA) can provide a reliable paycheck once a regular paycheck is gone. An income supplement in retirement may sound appealing but perhaps too appealing. Many people are buying SPIAs, even those who don’t need them. Make sure you get all the facts and weigh all options before jumping in.

Even SPIAs that seem quite safe and manageable have their own issues and are not appropriate for everyone. For example, people with little in retirement savings shouldn’t buy a SPIA and people with sufficient wealth relative to spending shouldn’t buy one either. So when does a SPIA come in handy? The answer is if a person has adequate retirement savings, but not enough to cover their expenses for a lifetime. Think of a SPIA as a form of forced savings for those that tend to have less control over their own spending.

Where Do Immediate Annuities Go Wrong?
Guaranteed income for life is a big time benefit, but it comes at a cost. The first concern is that you are giving up access to your money in exchange for the income stream. For this reason, if you are going to invest in an immediate annuity, it would be prudent to do so with only a portion of your total portfolio. As you age, access to money becomes more important, so this is a significant concern. Many retirees like to use an annuity to cover their
fixed costs, and describe it as similar to having a salary to meet regular expenses.

The second reason for someone not to buy a SPIA is someone who has enough income from Social Security, pensions, investments, rents, and other sources to pay their monthly bills. If additional guaranteed income isn’t needed, then a SPIA isn’t needed. It’s really that simple.

Third, most immediate annuities provide for fixed payments, which are not adjusted for inflation. Although we are in a low inflation environment today, who knows whether prices will rise substantially during the payout period of your annuity?

Finally, an investment in an immediate annuity is an investment in the company that issues it. The guaranteed stream of income is only as good as the financial stability of the insurance company that writes the contract. As we all learned during the recent crisis, insurance companies can run into big problems.

In summary, SPIAs could be a suitable idea for a specific segment of retirees who have built modest savings and do not have multiple sources of income. In contrast, people who either have little savings or who have accumulated greater wealth, should avoid buying a SPIA for obvious reasons.

One Offshoot to Owning an Annuity?

One ace in the whole that comes with owning an annuity, whether that be an immediate or deferred annuity, is that the Bankruptcy Court for the Eight Circuit just recently upheld a decision that exempted IRA annuities from the reach of creditors in bankruptcy proceedings. In laymen terms, monies held within qualified annuities, regardless of the amount, are protected against forced liquidation in the event of an individual bankruptcy filing.

Case in point, Mark Brunell, a starting NFL quarterback who after playing 18 years in the league (1993-2010) sadly found his way in bankruptcy court at the end of his football career. After earning more than $75 million in almost two decades of playing the game he loved, he ended his career so deeply in debt he was forced to sell most of his personal belongings including three Husky Rose Bowl rings and other prized mementos.

A religious man who tithed his church 10 percent of his salary, Brunell was unforgiven by his debtors. Owing about $20 million more than he had to his name, the quarterback took what he called “the only viable course of action,” filing for Chapter 11 bankruptcy reorganization. According to statements he filed with federal bankruptcy court, Brunell and wife Stacy had assets worth $5.5 million, but liabilities of $24.7 million.

For him, redemption came in the form of an annuity and though he lost a vast sum and is currently broke on paper, Brunell is likely to emerge from bankruptcy better off than 99 percent of those who lost everything. Under Chapter 11, he will be
allowed to keep his $3 million home and about $1 million he stashed away during his playing days in the form of a NFL annuity and 401(k) account that are protected assets under current bankruptcy law.

Final thoughts about annuities

This article attempts to portray that there are no free lunches when it comes to annuity investing. So when an insurance salesman, a financial advisor, or a broker broaches the topic of annuities with you, here are six questions that you should ask immediately:

1. **What type of annuity is this, and why do you recommend it for me?**

2. **Exactly how much will I pay in the first year of the contract, and then how much in subsequent years?**

3. **What will be your first-year commission on the contract, and what will you earn in subsequent years?** As show in this article, annuities are notoriously expensive, so you will want to understand the total costs, which include mortality and expense charges (“M&E”), administrative fees, income benefit riders, underlying fund expenses, charges for special features and the salesperson’s commission.

4. **Have I already maxed out other tax-deferred vehicles?** One of the big selling points of annuities is that they offer tax-deferral. However, if one thinks about it, if someone has enough money to invest additional monies upon maximizing-out retirement accounts then they are most likely to be in the higher marginal tax brackets during retirement (30-35%). Considering that capital gains tax rates are much lower (10-24%), the advantageous of annuity tax deferred investing is marginalized.

5. **Should I tie up my money with this contract?** Once you sign up for an annuity, it’s hard to get your hands on that money, and it can be expensive to do so. Make sure you have ample liquidity outside of the annuity before taking any plunge.

6. **How is this insurer rated by AM Best, S&P, Moody’s and Fitch?** Before the financial crisis, this question seemed silly, but now we know that insurance companies can go broke. Since the success of an annuity is predicated on the survival of the insurance company, it’s important that the company be highly rated.

To protect yourself against purchasing unnecessary annuities, do the same thing you’d do if you were buying a car or a camera: research your options to understand the different types of annuities, how they operate and when they’re appropriate. Ask salespeople about the charges for insurance and investment expenses, and how much they’ll be paid if you buy an annuity from them. However, in the end you will find in almost all cases they are not worth your time and hard earned dollars.
If you have a current annuity that you are concerned about and would like an objective free informative consultation or just simple advice on what do with your annuity, we would be more than glad to discuss the vital and key features of your particular annuity.

Ultimately, the most important outcome is that you reach your investment goals. On the surface, annuities may seem like a safe bet, especially during times of market volatility. However, they often have significant drawbacks that aren’t readily apparent to the average investor.

About RFA

Reilly Financial Advisors is a fee-only Registered Investment Advisor, aimed at helping our clients both define and achieve their individual financial goals through four unique service offerings:

1. **Wealth Building** – for those still accumulating their investment portfolios

2. **Wealth Management** – for those who have amassed their savings and have specific needs associated with their wealth

3. **Wealth Legacy** – for those who have accumulated a significant amount of wealth and face unique wealth transition needs

4. **Corporate Retirement Services** – tailored solutions for plan sponsors and participants

RFA, founded in 1999, services clients around the United States and in more than a dozen countries worldwide. As an independent advisor, we are able to provide our clients with the highest level of Fiduciary services which allows us to make investment decisions based solely in the best interest of our clients. Our goal is to be our client’s first point of contact for all of their financial needs, serving as a trusted financial partner for the long term.