Wealth Strategies

Annuities

ANNUITY

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Although many financial advisors consider annuity vehicles suitable for certain investors or certain circumstances, annuities with excessive costs are very rarely a sound investment solution. This is especially true in the context of variable and indexed annuities, which grew dramatically in popularity after the Great Recession of 2008 and offered most buyers a bad deal. In addition to the complexity of annuity products, many financial advisors don't even understand the nuances of the products they pitch. Because of these factors, **some investors are being given the false impression that they will receive something for nothing.**

It's important for you to understand that most annuities are overly complex, highly illiquid, more expensive than one might fathom, and often far riskier than investors understand. Annuities are a good example of the old saying, "if it sounds too good to be true, it probably 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 in return for regular disbursements beginning either immediately or at some point in the future. Beyond that, however, it can get quite complicated.

The Goal of Annuities

Annuities aim to provide a steady stream of income during retirement in order to minimize the risk of outliving income during one's golden years.

Types of Annuities

All annuities fall into one of two broad categories. **Immediate annuities** provide regular income payments right away or shortly thereafter, whereas most **deferred annuities** will annuitize—or begin paying you a lifetime

income stream—around age 90 by contract (although you can annuitize sooner if you wish). Many retirees do not want to annuitize because it gives up control of their assets. In response, many insurance carriers have modified products to allow income to be taken through an income rider without annuitizing the contract. Deferred annuities are also considered a type of long-term personal retirement account, and owners can save and invest on a tax-deferred basis with the option to receive a stream of income at a later date.

Immediate Annuities

Immediate annuities can provide a fixed or variable stream of income from an insurance company, depending on the type of immediate annuity purchased. With an immediate annuity, payments begin right away or within one year of the policy's issue. These contracts are also referred to as single-premium immediate annuities (SPIAs), because they are often purchased with a single deposit. SPIAs can help you manage the risk of outliving your money (longevity risk). More specifics on SPIAs are found later on in this piece.

Deferred Annuities

There are a few different types of deferred annuities:

- **Fixed Annuities:** Fixed annuities are generally considered a conservative investment, meaning they carry little risk, making them particularly attractive to retirees. Fixed annuities have characteristics similar to certificates of deposit (CDs) held 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 the 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 Annuities:** For investors who want access to more investment options, variable annuities offer subaccounts (similar to mutual funds within an insurance policy). Variable annuities have characteristics similar to those of a mutual fund or mutual fund portfolio.

- **Indexed Annuities or Fixed Index Annuities (FIAs):** These annuities are often described as hybrids between fixed and variable annuities because the insurance company will credit the owner a percentage of the increase in the price a particular index (e.g., the S&P 500). The owner does not invest directly in the index 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 3%). While the index being targeted might be a stock index, the returns will likely be more bond-like, as the underlying investments in the insurance carrier's general account are bonds.

Unwrapping Annuity Myths

After 2008 when the Great Recession hit and the stock market dropped sharply, scaring investors, variable annuities sales soared (as they were promoted as guarantors of one's money). With variable annuities, people once again felt safe investing in the stock market, knowing their investment would be protected for nominal insurance fees. Within the past decade or so, annuities wrapped within tax-deferred income riders became more prevalent, as salesmen began pitching them with a guaranteed yield that was several percentage points higher than U.S. treasury bonds with no risk to principal.

Unfortunately, annuities have been and are being sold to the public improperly, as there is indeed a significant cost. **Now, let us discuss two of the most common claims that insurance salespeople are using to prey on scared investors.**

Claim #1

"Annuities guarantee principal, income, and withdrawals."

A primary selling point of many variable annuities is the ability to pay a fee for receiving living benefit riders that claim to guarantee income, principal, and/or the ability to take withdrawals over the contract holder's lifetime. However, many benefit riders are only useful if the stock market has a prolonged period of poor performance or you live well into your mid-90s. **These are three of the most common riders that annuities provide:**

- **Guaranteed Lifetime Withdrawal Benefit (GLWB) Riders**
  This rider provides a guaranteed income stream (often a percentage of the principal amount) but lasts your entire lifetime, even if your principal would have otherwise depleted. This is the most common type of income rider today.

- **Guaranteed Minimum Withdrawal Benefit (GMWB) Riders**
  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).

- **Guaranteed Minimum Income Benefit (GMIB) Riders**
  This rider provides a guaranteed income stream lasting your entire lifetime, but the principal balance is usually forfeited after a set maturity period.

The Problem With Income Riders

The main goal of riders was principal protection against another year like 2008. Scared investors wanted to make sure their income stream would continue, and salespeople preyed on investor anxiety by making riders an easy add-on sale to annuities themselves. Unfortunately, many riders have strict conditions, features, and requirements.

Here are some facts that promoters of annuities don't typically tell you:

Income Riders Don't Guarantee Investment Performance

If an advisor or insurance agent says the annuity is "guaranteed to grow at 6% per year for the next 10 years," that's appealing. However, the income rider growth rate isn't quite what it sounds like. The growth rate is an artificial percentage that the insurance company uses to calculate the increase in the policy's benefit base. The benefit base is not something you can walk away with, and it's not available to withdraw as a lump sum; it merely represents the amount on which your payments will be calculated when you decide to start payouts.

Income Riders Cost Between 1% and 1.5% on Average

Income riders aren't free! When combined with other fees that we'll discuss later, investors could be looking at paying between 2% and 4% in aggregate on an annual basis. Any benefit there might have been is cancelled by high fees.

When You Annuitize the Contract, You'll Typically Turn Over Your Principal

The decision to annuitize (convert deposited funds into periodic payments) is typically irrevocable. By turning over your principal to the annuity provider, you are essentially losing control of your money. Because of this, many annuity policy holders choose not to annuitize.

Many Riders Require a Waiting Period

Before you can make withdrawals and receive your guaranteed benefits, many riders will require a waiting period. This waiting period is separate from the period where you may incur surrender fees for withdrawing funds (the surrender period). Some waiting periods can be as long as 10 years, so if there's any chance you will need your benefit sooner, be sure that you understand your contract and its conditions.

Your Investment Options Are Limited

Investors typically don't have much in the way of options for allocating their investments within the contract using most living benefit riders. And recent bear markets have led to some insurance firms limiting the growth of living benefit rider benefits by reducing equity exposure. This prevents the income benefit from rising rapidly and thus causing a liability for the insurance firm. It also means many investors might get a reduced benefit from the guarantee for which they are paying.

Income Riders Don't Adjust for Inflation or Cost-of-Living Expenses

Living Benefit Riders in Today's Environment

So what's changed in the last decade? Two factors have changed in recent years, making the risk/reward trade-off of living benefit riders less appealing than ever before:

- **The Raw Costs of Living Benefit Riders Have Increased**
  As volatility rose in the years after the financial crisis, many companies realized they needed to charge more simply to safely back the guarantees. What was once an annual 0.25%–0.50% rider guarantee now often costs 0.75%–1.25%.

- **Today's Investment Environment Has a Lower Expected Return**
  This expected return limits the potential for upside. This means that if a retiree is taking out 5% annual withdrawals and paying 2%–4% for guarantees, it might be nearly impossible for growth to exceed the sum of withdrawals and fees (when adding in the cost of the annuity itself).

Indexed Annuities (Formerly, Equity Indexed Annuities)

Given the pain brought by the last bear market to insurance companies providing retirement income guarantees, many guarantees have shifted to contracts where the annuity company has even more control of your money. Control has come in the form of **indexed annuities**, and these products are being sold to the public in the name of smoothing out market volatility.

In their simplest form, indexed annuities have minimums and maximums based on performance. A performance floor provides a minimum earned level of return, 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 psychology of offering downside protection with upside potential sells 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 indexed annuity. For example, many insurance companies only guarantee that you'll receive 87.5% of the 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, in many respects, indexed annuities have evolved to protect the benefit of the insurance company, not the clients they represent.

For insurance companies using indexed annuities, it's far easier to manage the costs of guarantee riders when they control all the money underlying the guarantee. The company has the flexibility to set participation rates, cap rates, and spreads at levels that ensure the product will be viable.

For these reasons, investors really aren't better off with an indexed annuity as opposed to a traditional brokerage account. Below is a graph illustrating the performance returns of a hypothetical indexed annuity vs. the S&P 500 index.

The indexed annuity's value, when considering its expenses and costs, was less than the value of the S&P 500 itself. These performance returns should show that a stock index fund left with enough time should far outperform (in value) an annuity with the rider described.

This graph shows the difference between investing $100,000 in the S&P 500 versus a hypothetical indexed annuity for the period between January 1, 2010, and January 1, 2020. The indexed annuity assumes a combined annual fee of 2% with 80% participation in the S&P 500 index and a 3% performance floor. Investors cannot invest in the S&P 500 directly and would need to use a proxy, like an index fund (where actual returns may vary from the index).

Claim #2

"Annuities are tax deferred and therefore extremely tax-efficient."

There is an element of truth to the statement that annuities are tax-efficient. Indeed, the interest, dividends, and capital gains within the annuity are tax-deferred. However, when the money is eventually distributed, you get hit hard with taxes. The ability to defer taxes on annuities is worth something, but there's a price to pay.

When one starts withdrawing money from an annuity, earnings (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, and other non-tax-deferred vehicles in which funds are held for more than one year. Investing in a tax-deferred annuity means 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). You're essentially trading the tax privilege of capital gains for a rate that could be twice as much.

And remember that tax deferral comes with another downside risk: there's a 10% penalty for withdrawals before age 59 ½ in retirement or non-retirement annuities. This penalty could be a problem if you need the money in an emergency, decide to invest in something else, want to retire early, etc.

What About Putting Qualified Retirement Money Into an Annuity?

Financial advisors and insurance agents may recommend variable or indexed annuities for accounts like 401(k)s, 403(b)s, and IRAs (which are already tax deferred) simply because that's where most people have built up their retirement savings. However, there are two very strong arguments against putting your IRA money into an annuity.

The first is that 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.

The second is that 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 mutual fund expense or custodial fee that you may already be paying for in your IRA. The resulting combination of fees will likely eat into any growth of your investment over time.

With that, let's get into the costs and high fees of annuities.

The True Cost of Annuities

While you don't have to be an expert on all annuity fees, knowing the most common types of fees will help you to evaluate products and ask intelligent questions. Different types of annuities—whether variable, fixed income, or deferred—charge different types of fees (as seen in the chart on the next page). 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 should be understood:

Insurance Charges

Also known as mortality and expense (M&E) fees or administrative fees, these charges pay for insurance guarantees automatically included in the annuity as well as the sale and administrative expenses of the contract.

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 recover the commissions the company paid to its advisor/agent). Be careful, as surrender charges can be significant and imposed for an extended period. Be sure to ask for details on any surrender charges to help ensure you have enough flexibility.

Investment Management Fees

These fees are assessed depending on the investment options within variable annuities and 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.

Rider Charges

Riders are optional guarantees available with some annuities. The most common types of riders are income riders or death benefit riders.

As you might imagine, most annuity fee structures are rather complicated and don't have a single flat-fee rate. Instead, they have several layers of fees that 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.**

VARIABLE ANNUITY EXPENSE DESCRIPTION	HYPOTHETICAL ANNUAL COST
Mortality and Expense Risk	1.18% | $1,180
Administrative Fees	0.19% | $190
Optional Guaranteed Minimum Death Benefit Rider	0.61% | $610
Optional Guaranteed Lifetime Withdrawal Benefit Rider	1.03% | $1,030
Fund Expense for Underlying Funds in Variable Annuity	0.94% | $940

Note: 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 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."

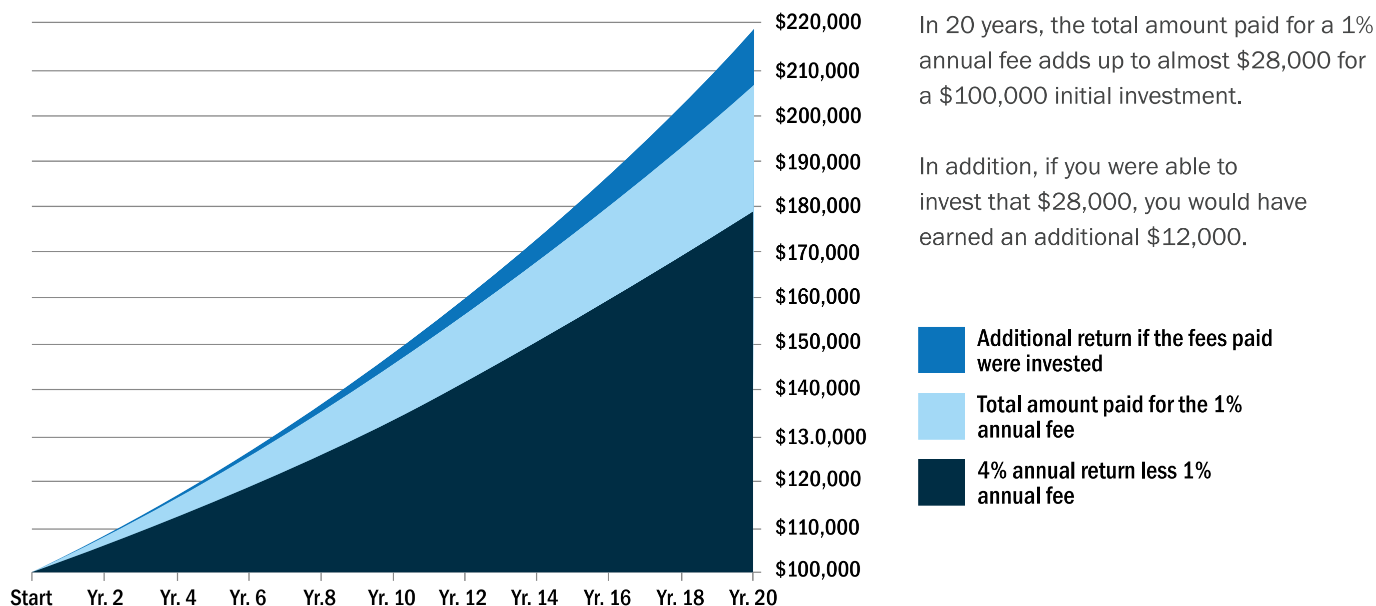
How Do Ongoing Fees Affect Your Investment Portfolio?

As illustrated on the next page, ongoing fees can dramatically reduce the value of your investment portfolio. This is particularly true over time. Why? Because not only is your investment balance reduced by the fee, but you also lose any return you would have earned on the money paid toward that fee. **This is why, over time, even small ongoing fees can have a big impact on your investment portfolio, making it difficult to reach your goals.** This is why other investments may provide a less costly way to accomplish the same objectives.

The following 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 and able to earn a return. Although this graph illustrates an annual annuity fee of 1%, imagine an annuity using riders at increased cost; the lost earnings due to exorbitant fees would be extraordinary.

Illustration of Ongoing Fees Over 20 Years



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

Other Reasons to Avoid Annuities

If false insinuations and exorbitant fees aren't enough to have you completely running for the exit doors, here are some additional reasons why annuities aren't likely in your best interest.

Taxation on Death (No Step-Up in Basis)

Upon your death, the person inheriting your annuity must pay income tax on any gain at his or her ordinary income tax rate. If the annuity is cashed in with a large gain, it may push your heir 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 tax liability for your heir.

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

Liquidity Problems

If you try taking out money from an annuity before age 59 ½, you will owe a penalty tax on any gains. Also, because actuaries need time to make assumptions workable and insurance companies need time to recoup larger-than-average commissions to agents, most annuities come with surrender charges—a meaningful reduction should you decide you want out of your contract early.

Stocks held in a brokerage account have neither of these downsides.

Also, because you're paying for tax deferral by taking a tax hit at the time of distribution, many investors are afraid to take money out, especially as annuities are taxed on a last-in-first-out basis, meaning that gains (100% taxable) are distributed before tax-free principal.

Complex Nature and Disclosure Issues

The complexity surrounding annuity products—especially variable annuities—combined with attractive incentives to the financial advisors selling them has left many clients with expensive investments they too often don't understand.

Is There Any Annuity That Might Make Sense?

While finding the best of the "not very good" isn't something we would typically encourage people to do, our top choice for an annuity would be a single-premium immediate annuity (SPIA).

What Is an SPIA?

An SPIA is a single-premium immediate annuity issued by an insurance company that allows a person to turn a lump sum of money into regular payments guaranteed for a period of time. An SPIA can provide a reliable paycheck once your regular paycheck is gone. While an income supplement in retirement may sound appealing, it might be too appealing given that many people who don't even need SPIAs are buying them.

Even SPIAs that seem quite safe and manageable have their own issues and aren't appropriate for everyone, so make sure to get all the facts and weigh your options before jumping in. People with little in retirement savings shouldn't buy an SPIA, and people with sufficient wealth relative to spending shouldn't buy one either. So when does an SPIA come in handy? **When a person has adequate retirement savings but not enough to cover their expenses for a lifetime. Think of an SPIA as a form of forced savings for those who tend to have less control over their own spending.**

Where Do Immediate Annuities Go Wrong?

Guaranteed income for life is a desirable benefit, but you must remember that it comes at a cost.

First, you give up access to your money in exchange for the income stream. So if you're going to invest in an immediate annuity, you should do so with only a portion of your total portfolio. As you age, access to money becomes more important, so this is a significant consideration. Many retirees like to use an annuity to cover their fixed costs, thinking of it as similar to having a salary to meet regular expenses.

Second, an SPIA may be unnecessary when you already have enough income from Social Security, pensions, rents, and other sources to pay your monthly bills. If additional guaranteed income isn't

needed, an SPIA isn't needed. It's really that simple.

Third, most immediate annuities provide for fixed payments, which aren't adjusted for inflation. Although we are in a low-inflation environment today, it's impossible to know whether prices will rise substantially during the payout period of your annuity.

Finally, remember that an investment in an immediate annuity is an investment in the issuing company. Your guaranteed income stream is only as good as the stability of the insurance company writing the contract. As we all learned during the Financial Crisis of 2007–2008, 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 don't have multiple sources of income. In contrast, people who have little savings or have accumulated greater wealth should avoid buying an SPIA.

One Upside to Owning an Annuity

One advantage that comes with owning an annuity, whether it be an immediate or deferred annuity, is that the U.S. Court of Appeals for the Eighth Circuit upheld a decision exempting IRA annuities from the reach of creditors during bankruptcy proceedings. In other words, monies held within qualified annuities—regardless of amount—are protected from forced liquidation in the event on an individual bankruptcy filing.

Important Questions to Ask

If an insurance salesman, a financial advisor, or a broker brings up the subject of annuities with you, here are six questions to ask:

- **What type of annuity is this, and why do you recommend it for me?**
- **Exactly how much will I pay in the first year of the contract, and how much will I pay thereafter?**
- **What will be your first-year commission on the contract, and what will you earn thereafter?** As we've shown, annuities are very expensive. You'll want to understand the total costs, including mortality and expense (M&E) charges, administrative fees, income benefit riders, underlying fund expenses, charges for special features, and the salesperson's commission.
- **Have I already maxed out other tax-deferred vehicles?** A big selling point of annuities is their tax deferral. However, if one has enough money to invest additional monies upon maxing out retirement accounts, he or she is likely in a higher marginal tax bracket during retirement (32%, 35%, 37%). Considering that capital gains tax rates are much lower (15%–23.8%), the advantages of annuity tax-deferred investing is marginalized.
- **How much will I have to pay if I surrender the contract during the surrender period?** After signing up for an annuity, it's difficult (and often expensive) to get your hands on that money. Make sure you have ample liquidity outside of any annuity you choose to purchase.
- **How is this insurer rated by AM Best, S&P, Moody's, and Fitch?** Prior to the Financial Crisis of 2007–2008, this question might have seemed silly. We now know that insurance companies can go broke. Because the success of an annuity is dependent on the survival of the insurance company issuing it, it's important that the company be rated highly.

Closing Thoughts

To protect yourself against purchasing unnecessary annuities, act the same way you would when considering any large purchase: research your options to understand the different types, how they operate, and when they're appropriate. Ask salespeople about the charges for insurance, investment expenses, and how much they'll be paid if you buy an annuity from them. In the end, you will find in almost all cases that the annuity is not worth your time and hard-earned money.

If you have a current annuity you're concerned about and would like a complimentary, objective

consultation (or just simple advice on what do with your annuity), we would be happy to have a discussion with you.

Ultimately, the most important thing 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 obvious to the average investor.

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

- **Wealth Building**
  For those still accumulating their investment portfolios
- **Wealth Management**
  For those who have amassed savings and have specific needs associated with their wealth
- **Wealth Legacy**
  For those who have accumulated a significant amount of wealth and face unique wealth transition needs
- **Corporate Retirement Services**
  Providing tailored solutions for plan sponsors and participants

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