Annuities Can Be Good, Bad or Ugly. Which Is Which? Part I

Annuities can be good, bad or downright ugly. How can you tell if your annuity is good, or if you should consider purchasing one? And what's an annuity, anyway?. In this two-part series, I'll begin with a review of the "bad and ugly" annuities (most variable annuities). Next month I'll review "good" annuities (primarily immediate and deferred fixed annuities).

<u>How Variable Annuities Work:</u> Annuities have two phases: 1) the investment/accumulation phase and 2) the payout phase. During the investment/accumulation phase, clients place taxable or after-tax assets in an annuity, invest in the investments offered by the annuity company and sit back and wait. Like any investment, the investor hopes to see his/her investments appreciate. At a certain point, the annuitant (annuity owner) flips a switch and converts this account into a stream of income (note: some annuitants never "flip the switch" by choice). When this happens, the size of the monthly annuity payment stream is based upon actuarial tables. If you live past your predicted life span, you continue to collect payments and you "won" in terms of getting more out of your annuity. If you live a shorter life than the actuarial tables predict, you've lost in two ways: your life ended prematurely and so did your payment stream – unless you have a joint annuity that continues to pay your annuity joint owner (spouse).

<u>Objections to Variable Annuities:</u> It all sounds wonderful so far but Fee-Only advisors like myself have reason to be suspicious of advisors who flog variable annuities. I've been called by prospective clients who related that advisors locked up most of their liquid investments into annuities. The annuity seller collected a tidy commission while the client is handcuffed and subject to the annuity rules and fees.

Here are some of the problems with variable annuities and indexed variable annuities:

1. Annuities are complex and hard to understand (good for the seller, bad for the purchaser). In my opinion, the annuity investor is easily confused and dazzled by projected return charts and promises of “never running out of money in retirement.”
2. Annuities can be expensive (poor disclosure by the seller regarding expense and mortality charges + expensive investments in the line-up).
3. Annuities can be restrictive (heavy redemption penalties). Annuity companies can pay handsome commissions to annuity sellers, esp. if the funds are locked up for 10 years or more.
4. Indexed variable annuities are sold with the attractive story that an investment does as well as the market (e.g. S&P 500) PLUS the investor has downside protection. What’s not to like? I’ve been told by annuity sellers, with straight faces, that indexed variable annuities have “zero costs.” This is far from the truth since the annuity firm makes money in part by gobbling up all of the dividend income an annuitant otherwise would earn in a regular account. Dividend income can make up 2% or more of an annual return; the upside return potential is diminished in exchange for some support on the downside. This isn’t clearly explained to the investor.
5. The annuity investor is pinning his/her future on the financial strength of the annuity provider. If it goes under, there’s no guarantee the funds can be recovered.
6. There are important tax consequences if purchasing an annuity in an IRA (qualified annuities) or purchasing it with after-tax money (non-qualified annuities). It’s reckless to invest in an annuity without considering the tax consequences!
7. Non-qualified annuities are disadvantageous to inherit

vs. regular taxable investment accounts because there is no “step-up” in cost basis.
8. Worst of all, selling them can pose a serious conflict of interest (the seller makes out well, the purchaser can… er um…be screwed).

Fee-Only (no products sold, no commissions) advisors put our clients’ interests before our own *in large part because we don’t sell products that puts the interest of the seller before the client.* In other words, *<u>we’re Fiduciaries</u>.* Advisors who sell annuities can’t make this Fiduciary guarantee. Regretfully, previous government administration moves to hold annuity sellers (and retirement plan advisors) more accountable have been shelved this year.

<u>Recent Positive Trends in Variable Annuities:</u> A minority of variable annuity providers take a different tack by appealing to Fee-Only (no commissions) advisors. These annuities have lower fees and greater transparency. All-in fees formerly in the 3-4%+ annual range can be as low as 1% or less. Accordingly, such annuities *may* have a role in a client’s portfolio <u>in the content of an overall financial plan and investment portfolio.</u> I stress <u>context</u> because annuities should be evaluated by an advisor who has no skin in the commissioned product game. Finally, investors in ugly annuities have access to the IRS 1035 Exchange rule that allows annuity holders (before the annuity is annuitized) to roll out of their ugly annuity and into an acceptable annuity of the same type *as long as surrender penalties don’t stand in the way.*

By Eve Kaplan, CFP® Professional

Which is Best: Lump Sum or Pension Annuity?