Better Annuities Are Fixed Annuities

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In my prior article I explained the kinds of annuities that are "bad" or "ugly" for investors: virtually all variable annuities, including indexed annuities (that are misleadingly categorized at a type of fixed annuity). My objections have to do primarily with cost and the fact that they often are sold to people who don't need them or understand them (note: there are some newer variable annuities with lower costs that are being made available to Fee-Only advisors like me).

In this 2nd article on annuities, I'll focus on what kinds of annuities may be considered "good" for investors: fixed annuities.

Reminder Regarding How Annuities Work: Annuities have two phases: 1) investment/accumulation phase and 2) pay out phase. During the investment/accumulation phase, clients place taxable or after-tax assets in an annuity, invest in annuity investments (if they're variable annuities) and – like most investment accounts – hope to see these investments grow. At a certain point, the annuitant (annuity owner) flips a switch and converts this account into a stream of income. The amount of the monthly payment is based upon actuarial tables – if you live past your predicted life span, you continue to collect payments and you've "won" in terms of collecting more payments than your actuarial average y. If you end up living a shorter life than the actuarial tables predict, you've lost in two ways: your life ended early and so did your payment stream – unless you have a joint annuity that continues to pay your annuity joint owner or you accepted a lower stream of payments in order to have some of the principal go into your estate.

One Type of Annuity Is The (Increasingly Rare) Pension: Pensions begin when you retire or when you turn 65. Sadly, employers have dropped these plans due to their expense. In place of pensions, employers of larger firm are offered 401k plans that can have varied outcomes – depending upon the investment skill of the employee and market luck.

"Good" Annuities That You Can Purchase: Fixed annuities that pay a guaranteed monthly amount begin immediately (called SPIA) or begin a stream of income in the future (DIA). Deferred fixed annuities are sometimes called longevity annuities since they can be set to begin payments when the annuitant is much older: age 75, 80 or even older. The stream of payments you receive are governed by interest rates, with some guaranteed minimum provided. When interest rates are higher, fixed annuities are more attractive. Here are some things to consider:

1. A Fee-Only Advisor is best suited to analyze and select this type of product because it should be considered in the context of an individual's entire financial plan. A Fee-Only advisor does NOT collect a commission or otherwise benefit from recommending this type of product.
2. The tax consequences of an annuity purchase are complicated and should be reviewed and discussed by a Fee-Only Advisor. Taking after-tax money and investing in a fixed annuity means the investor is giving up the opportunity of investing this same money in stocks that are taxed at lower long-term capital gains rates. The investor also is giving up the ability to offset capital gains with capital losses – another attractive attribute of investing in stocks with after-tax money. So does it ever make sense to take after-tax money and invest in a fixed annuity. Funding a fixed annuity with after-tax money can make sense if a client has excessive earned income and he/she wants to defer income beyond 401k and

other qualified plan restrictions.

3. It probably makes more sense to use tax-deferred money to invest in a fixed annuity than after-tax money because annuity income is taxed at ordinary income tax rates just as interest and dividends are taxed at ordinary income tax rates in after-tax accounts. This is in contrast with the fact that it almost NEVER makes sense to take after-tax money and invest in a variable annuity (that taxes all gains at ordinary income tax rates).
4. *Ultimately decisions about using after-tax or tax-deferred money to invest in a fixed annuity come down to the asset allocation of the client, his/her financial goals, the percentage of the portfolio in after-tax vs. tax-deferred money, projected future tax rates for the client(s), etc.*
5. Annuities have estate planning consequences, depending upon if the annuity has been annuitized yet (or not). Annuities—both variable and preferred – have disadvantages versus after-tax investments if inherited.
6. An annuity is illiquid (once you set it up, you can't cancel it) so annuities typically should not exceed 20-25% of a client's liquid investments.
7. An annuity may be appropriate for individuals who overspend, need a steady monthly source of income to supplement Social Security and/or have longevity genes.
8. On the other hand, individuals who receive both Social Security and corporate pensions probably don't need to consider this additional fixed stream of income.
9. Most fixed annuities don't adjust for inflation so a fixed stream of income will decline in purchasing power over time. Annuities with an inflation-adjustment feature are available but naturally they cost more.

The US government is mindful of the looming Boomer disaster of underfunded retirement accounts. New regulations are being considered to allow 401k investors to set aside a portion of their 401k accounts in a fixed annuity. Another idea being considered is a “retirement bond” that would function like a regular bond investment but would transform into a fixed annuity in the future (after retirement). More drastic measures will be needed to help retirees who are unprepared to fund their retirement.

In sum, annuities are complex planning products with complicated attributes. A Fee-Only advisor who evaluates your entire investment portfolio AND your entire financial plan is best equipped to review them. In my practice, I’ve had a number of clients come to me with variable and fixed annuities they already purchased before we began working together. My job is to roll over unattractive, expensive annuities (typically variable annuities) into more attractive (less costly) options whenever possible. Fixed annuities typically are less problematic and typically are retained. I consider these to be a type of fixed income product my client holds in his/her overall portfolio.