Everything You Need to Know About Annuities

Let's start with an explanation of what an annuity is: It is a contract with an insurance company under which you, the consumer, pays a lump sum in exchange for certain benefits such as a steady income throughout your retirement years. There are three kinds of annuities: variable, fixed, and indexed. Each type can establish a solid retirement plan, yet may also lend itself to misuse. Variable annuities have gotten a bad reputation in recent years because they are often sold to people, especially seniors, for whom such unpredictable returns are inappropriate. Fixed annuities are less vulnerable to shifts in the market, so while they can't bring in extra returns during a healthy financial quarter, they keep your losses at a minimum when the economy is weak. Lastly, indexed annuities combine elements of both, providing both a guaranteed minimum return as well as a potential for higher gains if the stock market prospers.

VARIABLE ANNUITIES

In the case of a variable annuity, those benefits are based on an investment package. The insurance company would allow you to choose from a variety of investment opportunities, and the regular payments they make out to you afterwards would be determined by how well your investments are doing. Variable annuities have potential for growth.

But there is an equally big potential for loss. If whatever you invest in doesn't do well, neither does your annuity, and your regular payout will follow suit. To curb this risk, many annuities offer a guaranteed minimum rate of return from your insurance company for an extra fee. Add sales commissions, management fees, and insurance charges to the mix, and you're facing some substantial chunks getting cut out of your returns.

A final warning – if you choose to cash out your annuity too soon, you'll most likely get hit with a surrender charge for early withdrawal. Typically, variable annuities charge penalties of up to 10% for withdrawal over the first few years of the investment, with the penalty gradually shrinking each year.

FIXED ANNUITIES

Fixed annuities, as the name suggests, are contracts under which the insurance company pays the consumer a fixed amount, usually on a monthly basis. You can decide whether you

want your annuity to last for your lifetime, or for a specific length of time ("term certain"), or for both—for your life, but with a guaranteed period of payment in the event of your premature death. In the case of a fixed lifetime annuity, one might pay the company $200,000 in exchange for a guaranteed income stream of $1,000 a month for the rest of his life. The amount of the payment and the cost of the annuity will depend on his age since the company, in determining these numbers, will be making a prediction of how long it will have to pay – in other words, the estimated life expectancy. In this example, if the consumer lives longer than 17 years, he will "win" because the insurance company will ultimately pay him back more than $200,000, but if he lives for a shorter period of time, he "loses" (in multiple ways, really) because he will receive back less than his investment. This could be a very poor investment if the consumer were to die early due to illness or an accident. For instance, if the buyer of the annuity in our example passed away after just five years, he would have received only $60,000 in payments on her $200,000 investment.

For this reason, many consumers purchase annuities with term certains meaning that if one were to pass away before the end of the term, payments would continue for his beneficiaries or they would receive a lump sum upon his death. For instance, if one were to buy the annuity in our example with a 10-year term certain and were to pass away from five years, the insurance company would still pay out an additional $60,000 to the heirs, either by continuing the monthly payments or in a lump sum. Of course, the length of the term certain will affect the amount of monthly payments since the insurance company will be committing to pay for a longer period of time no matter how long you live. If you want a longer term certain, you will either have to pay more for the annuity or accept a smaller monthly payment.

INDEXED ANNUITIES

An indexed annuity is a form of variable annuity with its returns on a specified equity-based index, such as the S&P 500. A broker or agent will most likely use the phrase "It's the best of both worlds" while trying to make the sale, which isn't untrue. Insurance companies will usually offer a guaranteed minimum return on an indexed annuity, much like a fixed annuity, so even if the stock market suffers, you can rest easy knowing that you still have your payout. If the stock market does well, you reap the additional benefits.

However, there is often a limit to exactly how much of a benefit you reap, known as a cap. Because you are guaranteed a minimum return no matter what, you also do not receive the full returns when stock prices rise; there must be a balance between the security of a fixed annuity and the risky gains of a variable annuity. For instance, let's say that you purchase an indexed annuity that's tied to the S&P 500. Your contract states that you have a cap of 8%, and insurance the company takes an additional 3% cut of your returns as a management fee. If the S&P 500 were to earn 11% during a particular year, your returns would still be limited to 8%, minus the company's 3%, leaving you with a 5% return.

THE RAP ON VARIABLE ANNUITIES

Variable annuities are extremely complex products and it's doubtful that very many consumers fully understand them when they purchase them. That doesn't mean that they're bad, just that they're confusing. In addition, they provide generous premiums to the brokers who sell them, payments which many of the brokers don't disclose. They also generally don't disclose whether they are paid more or less by one insurance company than another, or whether the annuity being sold is the best option for the consumer.

This relates to another debate going on in the financial services industry. Broker-dealers are held to a "suitability standard," rather than to a "fiduciary standard." This means that they can sell any products and give any advice that is reasonably applicable to the client's financial situation. A fiduciary standard would require them to act in the best interest of the client, meaning that they provide full disclosure at all times and exercise greater caution when offering investment counsel. President Obama's administration is seeking to apply the higher fiduciary standard for all retirement accounts.

All of this means that the purchaser of a variable annuity needs to be cautious and should seek a second opinion. In our experience with clients, some have been greatly helped by variable annuities, receiving both higher retirement income when investments flourish, and, more often, a reliable income even when the investments flounder. For others, however, variable annuities have been problematic. This is especially the case when a senior needs to access capital to pay

for long-term care or accounts need to be transferred to qualify an ill spouse for MassHealth benefits. In either case, this may require withdrawal of funds that have decreased due to a drop in asset values, as well as early-withdrawal penalties. For these reasons, older or sicker seniors should be wary of purchasing variable annuities.

THE BENEFITS OF FIXED ANNUITIES

Fixed annuities, on the other hand, are much less complicated products. They are often used in MassHealth planning, which will be the subject of another blog post. But they can also be used to guarantee a retirement income no matter how long you live. Some people call this "longevity protection." For instance, let's assume you plan to retire at age 65 and you have calculated that with your Social Security income, savings and investments, you have enough money to live comfortably for 20 years, taking into account likely inflation during that time. So, you plan to buy a fixed annuity with a 20-year certain. Now, that's fine if you only live to age 85, but what if happens if you live longer than that?

A bit more than a fifth of men and a third of women who are 65 today will make it to age 90. Your own health and your family's longevity may give you some guidance as to whether you will need income past age 85. But based on these statistics, if you're a woman (or are married to one) your planning should make sure that you have sufficient income until 90. (You may not need to be as concerned after age 90 since only 13% of 65-year-old women and a measly 7% of 65-year-old men make it to age 95.) A fixed annuity can be a solution since it will continuously and consistently pay for the rest of your life, even if you run through your savings and you live to be 100.

Variations can enhance the usefulness of immediate annuities for this purpose. For instance, if you calculate that you can live on current income in exchange for more income in the future, insurance companies will pay you a higher monthly benefit starting out in the future. This is called a deferred annuity. For example, if at age 65 you were to purchase an annuity that did not begin paying until age 85, it would pay you far more than if it were to begin paying immediately. According to one online annuity calculator, a 65-year-old woman paying $100,000 for an immediate annuity would $528 a month, starting now. If she postponed payments until

age 85, she would receive $3,608 a month beginning then, almost seven times as much (and much more than three times the $1,125 per month she would receive if she'd just waited to purchase the same annuity until she was 85). She would, of course, have given up both the income of $126,708 ($528 x 12 x 20) and the use of her capital, but it might be a good hedge against outliving her savings.

CONCLUSION

As you can see, annuities are complex financial products. And no one, unless they can accurately predict the future, can know exactly what planning steps they can take. But that said, annuities, whether variable, fixed, or indexed, can be valuable retirement and longevity planning tools. Just follow these four rules:

i. Get expert advice.
ii. Get a second opinion.
iii. Sleep on it.
iv. Diversify. Don't put too much of your savings into any one type of investment, whether that be variable annuities, immediate annuities, stocks, or bonds.

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