Money Matters: Annuities

Introduction

Annuities are contracts offered by insurance companies in which you make a lump-sum payment or a series of payments to them and in return you receive a regular disbursement immediately or at some point in the future. Annuities come in different flavors with a myriad of options (riders) that may be offered making for a complex combination and choices, but the overall goal of all annuities is to offer a "guaranteed" steady stream of income either for the life of the purchaser(s) of the annuity or over a fixed time period in exchange for you surrendering your money to the insurance company. It is vitally important that the insurance company you purchase the annuity from financially stable so that it can meet its contractual obligations (Many states guarantee up to $100k for annuities - nolhga).

Disclaimers

- Financial information is by nature dynamic and ever changing, as a result you should assume any information presented here as dated and in need up update before any decisions should be made.
- Your situation is unique information provided here is general in nature tax many details may not be mentioned that may have impact on your financial situation. Make sure you investigate fully any topic that may be used to make a decision. Additionally, tax laws are complex and many times subject to vary based on the individuals income. Make sure you understand the implications for your situation.
- Discussions assume all tax rules are being followed. For example if you withdraw funds from a tax deferred account before retirement age there are penalties, and guidelines provided below will likely not apply.
- Annuities are extremely complex and new variations and options are constantly being introduced. Information presented here may be outdated.

Classes of Annuities

I tend to place annuities in three different broad categories:

- **Fixed Annuities** – Pay out a guaranteed amount of money. Fixed annuities can either be effective immediately (Immediate fixed Annuity) or at some date in the future (Deferred fixed annuity). These types of annuities are very straight forward and easy to understand. In these annuities you give up your money to the insurance company in exchange for a regular payment from the company for a fixed period of time or until you die.
- **Variable Annuities** –Offer the purchase the option of investing in a menu of mutual funds where the value of the annuity is based on the performance of these funds over time, providing the opportunity to grow the value of the annuity based on the performance of the mutual funds selected by the purchaser. In contrast to Fixed Annuities the purchaser retains control of their money during the accumulation phase but may face large fines if they decide to withdraw their money from the annuity prematurely. These are complex and have large fees and various restrictions associated with them. *These products should be avoided.*
- **Fixed Index Annuities** – is linked to a market index (ie S&P 500), guarantees no loss of capital, has limited fees and will generally allow withdraw of a certain percentage (ie 10%) on a yearly basis with no penalties, and will allow access to full fun after a fixed period (ie 6-8 years). These instruments offer the stability of bonds and tend to provide better return over longer periods of time.

Tax Considerations

When it comes to tax treatment annuities are similar to 401k's and IRA's in that the growth of the value of annuity is tax differed, and as a result disbursements you receive are subject to income taxes. Keep in mind; if you invest after-tax dollars when purchasing an annuity, it is only the growth of the fund from the distribution that it taxed as regular income. For example if I invest $100k in an annuity that grows in value to $150k then $50k (1/3) of the distribution will be taxed as regular income. Unlike 401k's and IRA's money invested in an annuity doe not lower your taxable income. However, if pre-tax money is used to purchase an annuity (ie convert a 401k to an annuity) distributions are 100% taxable.

Considerations

Generally people look at annuities and a means of guaranteeing a certain amount of income (similar to a pension) to ensure a certain baseline income in retirement, so it is important to understand what your bare minimal baseline income requirement is in retirement. Remember Social Security will likely meet a large portion of this, purchasing a Deferred, Immediate or even a Fixed Index Annuity can be a great option to fill the gap.

While Variable Annuities offer the chance of growing your payout, in some sense they are undermining the entire reason most people want an annuity by adding variable performance in the equation. Rules, and restrictions of these types of annuities severely hinder performance compared to a similar investment one might make in the stock market in an investment accounts. Variable annuities have high minimal annual fees, caps on performance (ie if an index goes up 25% in a given year you can only realize up to 8% of that growth) and surrender charges. These pitfalls are usually not highlighted by your sales representative, but you can bet the sales representative will likely be pushing this type of annuity over a fixed annuity because sales commissions and up-front fees on Variable type of annuities tend to be quite high compared to fixed annuities.

Circles in Circles

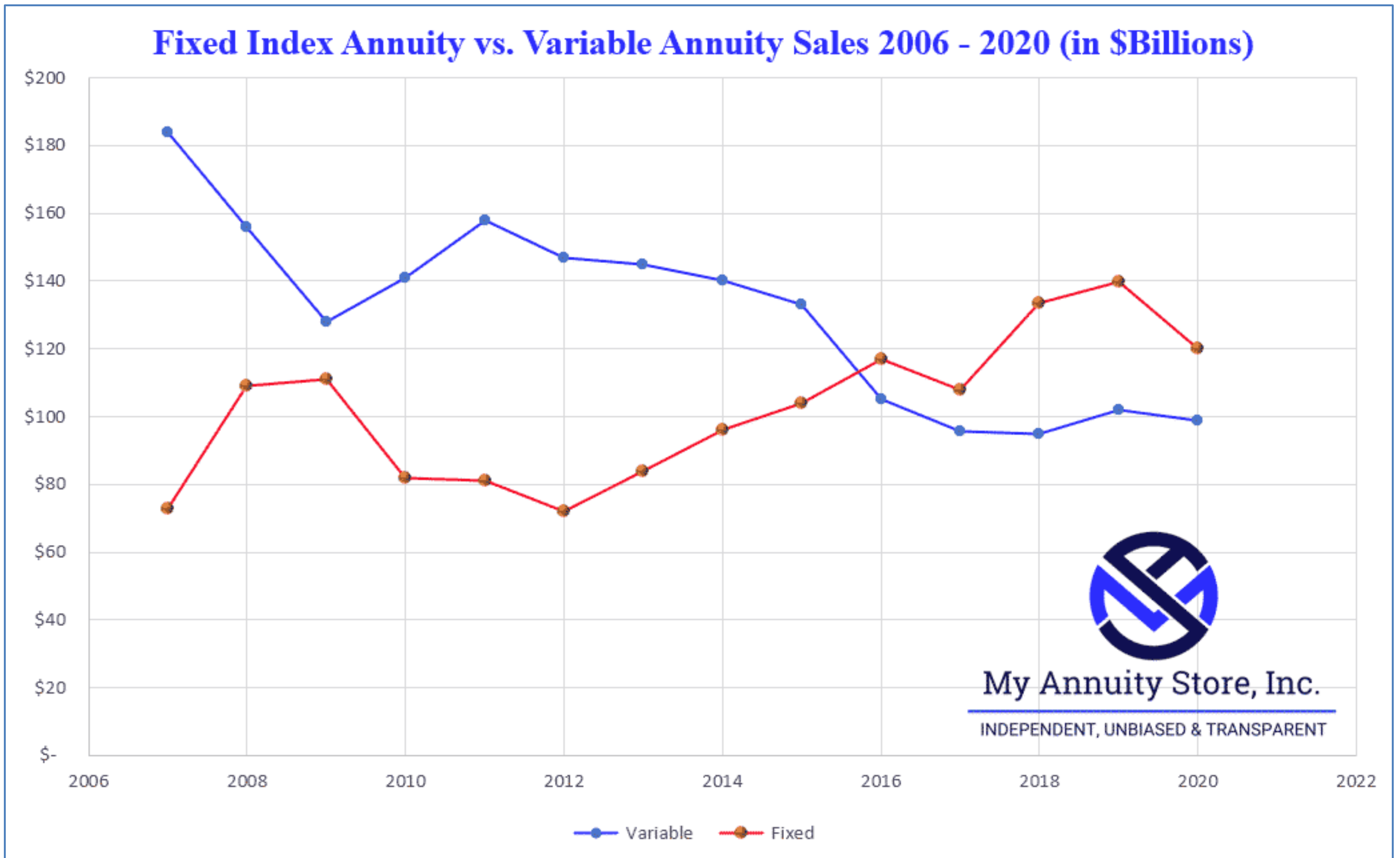
While I prefer to classify annuities in two broad classes there are many variations of annuities some of the variations are listed below with a very brief description. To add confusion terminology is not fixed so the same type of annuity can be called different things by different companies selling the product.

Name	**Class**	**Description**
Ordinary Annuity	Fixed Annuity	After annuity has been purchased, regular distributions begin in the very near future and continue for fixed period.
Immediate Annuity	Fixed Annuity	After annuity has been purchased, regular distributions begin in the very near future and continue either for a fixed period or until the recipient dies. Common names: Single-Premium Immediate Annuity (SPIA)
Deferred Annuity	Fixed Annuity	Fixed annuity distributions will not begin until you reach a certain age. These annuities will pay better than an immediate annuity since the insurance company has time to invest the money provided. Common names: Longevity Insurance
Individual Retirement Annuity	Both	Share many of the same restrictions and rule as an IRA but is used to purchase a Fixed or Variable annuity.
Variable Annuity	Variable Annuity	A deferred annuity where investments are made in a limited list of mutual funds. Pay out is linked to the performance of the selected mutual funds during the accumulation phase (ie time between purchase of the contract and the beginning of the distribution phase). Account value can decrease if the selected funds perform poorly. Variable Annuities are known for their higher fees. Typical fees for variable annuities include Surrender Charges, Mortality and expense risk charges(typically 1.25%), Administrative Fees, Fund expenses for each mutual fund, Other fees and charges. *Conclusion: Avoid Variable Annuities*
Index Annuity	Index Annuity	A deferred annuity where payout is linked to the performance of an Index during the accumulation phase (ie S&P 500, etc.). Generally lower/no fees for account (Riders will have fees). Generally a certain percentage on a yearly basis can be withdrawn without penalties. Ref 1, 2

Riders

Annuity riders are additional provisions attached to a contract that are not usually found on standard plans. There are a number of different riders, and variable fees associated with them (Fees for variable annuity riders are generally a yearly based fee), provided below are some of the more common ones (ref: Annuity Riders Explained):

- **Death benefit** – A designated beneficiary(s) are entitled to receive an amount of money not less than the sum of the total premiums paid less withdraws and payouts.
- **Nursing Home/Long-Term Care** – If you end up needing long-term care this rider will provide extra income to help cover the cost.
- **Inflation Protection** – Raises your monthly income by a set percentage every year to help combat inflation.
- **Refund** – If, at the time of your death your total annuity payments received do not equal the premium you paid your designated beneficiary will receive the difference.
- **Impaired Risk** – If you have an illness that will reduce your life expectancy, the insurance will pay you more per month.
- **Commuted Payout** – Allows you to withdraw a lump sum from the annuity should the need arise.
- **Guaranteed Minimum Accumulation Benefit** – Applicable to differed variable annuities during the accumulation phase ensures the value of the account will not be less than the premiums paid in regardless of market performance. Some companies offer the ability to lock-in gains on a yearly basis.
- **Guaranteed Minimum Withdrawal Benefit (GLWB)** – Guarantees you an income for life without having to annuitize (ie you don't have to convert to an immediate annuity). This can be helpful if your annuity has –and continues to- do well because you can still realize gains on your premium while receiving monthly payments. You can also normally access any remaining premium during your payout phase, minus payments made and previous withdrawals.
- **Disability, Unemployment & Terminal illness** - These riders are generally widely available for both fixed and variable annuities and are fairly simple as they are future "what if" scenarios. If you become disabled, lose your job, or find out that you have a terminal illness, the insurance company allows you to access a portion, or even your entire premium, without surrender penalties. Ask your trusted financial advisor for more information on these riders as each company handles these situations differently.



Typical Variable Annuity Fees

- M&E (mortality and expense) – average around .50%
- Sub-Account Fees – average 1.00%
- Optional Rider Fees (income rider or death benefit rider) – Average 1.00% each

Typical Index Annuity Fees

- No Fees for Base Index Annuity
- Optional Indexed Annuity Rider Fees – Average 1.00%

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Factors to Take Into Account When Considering Annuities (Ref: Charles Schwab)

Factor	Immediate fixed annuities	Variable annuities with GLWBs	Traditional portfolio
Income guarantees*	Insurer pledges to make income payments that last for a fixed period or life	Insurer pledges to protect minimum annual withdrawals from the variable annuity for life	No guarantees on lifetime income; interest paid on bonds subject to credit risk of issuer; dividends at risk of reductions or elimination.
Liquidity	No liquidity after a lump sum is turned over irrevocably to the annuity provider	Investor retains control over assets and doesn't turn over lump sum to insurer; penalties or loss of guarantees may apply if annual withdrawals exceed a guaranteed minimum	Best liquidity, depending on investment choices and market performance
Market participation	None; annuity provider assumes market risk	Owner has potential to participate in market growth, after accounting for fees and withdrawals	Maximum market participation, accompanied by maximum market risk
Flexibility	Inflexible; initial lump sum investment is irrevocable.	Investor retains control over investments, subject to limitations on choices offered in annuity chosen; more flexible than immediate fixed annuities	Most flexible—investor retains full control over investments
Longevity	Simplest form of protection against longevity risk; initial payout generally higher than variable annuities with GLWBs, but generally fixed	Provides guaranteed withdrawals for life from a portfolio of investments; initial payout generally lower than immediate annuities, but potential to increase depending on market performance	A disciplined spending plan can lead to high confidence that assets won't be outlived, but does not promise lifetime income
Cost	Cost embedded in up-front cost of purchase	Annual fee charged for variable annuity and GLWB rider	No added insurance or annuity fee; transaction fees and investment costs still apply

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Strategies

Annuities have different characteristics based on the type of annuity you purchase, so may play a different role in your retirement planning based on your need. Provided below are some strategies of how annuities might be applied.

- **Longevity Insurance** – Here you purchase a Differed Fixed Annuity that will not kick in until you reach a certain age, (ie 85 years old). This is one way to help ensure you don't out-live your savings. Delaying when you begin receiving your payout will result in a larger payout since these amounts are directly correlated to your age when you begin receiving payments. The risk to this approach is that you die before you begin receiving your payments. This approach could also be used to help ensure if a couple is dependent upon Social Security, that if one spouse dies, the other will have funds that may make up for the income stream from SS for that spouse.
- **Minimal Cost of living makeup** – If you have determined Social Security and any other fixed benefits (IE pension plans) are not enough to cover your minimal cost of living, purchasing a Immediate Fixed Annuity may be one way of filling that gap, ensuring you will always have the minimal amount of money you need for retirement.
- **Reducing Market Risk Exposure** – A Variable Annuity with a Guaranteed Lifetime Withdraw Benefit (GLWB) may play a role in your retirement plans if you have a large some of money for retirement but want to remove some of these funds from market risk (ie market downturns). The trade off of this is that the Variable annuity will always under perform the market over the long term due to purchasing expenses, ongoing fees and rider expenses, but may allow the you sleep at night when the market suffers a 50% downturn in a given year.
- Bond Substitute – Fixed Index annuities preserve the initial investment while offering the opportunity to have superior return when compared to bonds in the long run. While bonds to guarantee a certain percentage of return, Fixed Index Annuities are linked to the performance of a market index and may have years where no return on investment is realized (short term risk).
- **Laddering** – Fixed Annuities share many characteristics as bonds, as a matter of fact bonds could be considered one type of annuity. A popular strategy with bonds is bond laddering; this strategy could also be applied to annuities. Laddering is where instead of a one-time purchase of a large annuity, you purchase smaller increments of annuities over time. Since payout of annuities are directly associated with interest rates, if interest rates rise you will be in a position to benefit from the higher interest rates, and associated increase in payout rates for newly purchased annuities. Additionally annuities purchased as you are older will have a larger payout since payouts are tied to your age when the distribution phase begins. One more benefit of this approach is that since many states guarantee fixed annuities up to 100k, the net effect is you may have more funds backed by the state since instead of having one large annuity that may exceed the guarantee limit you have multiple smaller annuities each of which benefits from the states guarantee.

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A few key points to keep in mind

- **Consider the financial strength of the company** - While many states backup annuities up to ($100k) annuities are only as good as the company you purchase them from, so it is vital the company you are dealing with has an exceptional credit rating.
- **Don't think of annuities an investment**, but as insurance. Annuities are terrible investments; they will always under perform when compared to the market in the long run. Like casinos the insurance companies always wins in the long run. You may be lucky and get the better end of the deal (ie live a very long time if you purchase a fixed annuity), but statistically the insurance company always wins (that's a good thing since they would go out of business if they didn't). Annuities may still play an important role in your retirement plan as insurance for income stability.
- **Shop Around** – Fees, payouts and expenses for Variable Annuities can vary greatly from company to company, so you should comparison shop when looking for an annuity.
- **Inheritance** – Unless you purchase rider(s), any funds you invest in an annuity will probably be gone when you die, as such these are not good tools for passing an inheritance.

Case Studies

In the next few pages we will review a few different scenarios where annuities might be something to consider.

Case #1 – Longevity Insurance

- Jack(65) and Jill(60)
- Goal: Ensure living expenses can be met if one of them dies and social security income is greatly reduced. Morbidity tables indicate average life expediency of Jack to be 82, Jill 84. If one of them dies, social security income will drop by $25,000 leaving a $10,000 shortfall of meeting the minimum cost of living ($45,000).
- Combined retirement savings: $400,000
- Minimum cost of living: $45,000/year
- Sources of fixed income
  - Jack Social Security: 35,000/year
  - Jill Social Security: 25,000/year
- **The Gap** $10,000 in todays dollars, **$15,216** by 2036, assuming a 2.5% inflation rate.
- Annuity options that will provide **15,600/year** starting in 15 years (**2036**) Jack age 80, Jill age 75 are provided below.
- **Remaining funds**: After annuities purchase, Jack and Jill **$255,763** for as a buffer to last the rest of their life's. Since they did this calculation based on the Minimum cost of living they may want to be fairly conservative on how they invest these funds.

Premium	Minimum Payout	Income Annuity Options
$136,856	$0	Joint Life Only. You will receive this income during the lifetimes of both annuitants. Annuity payments continue until the death of the last annuitant. However, your beneficiaries do not receive a death benefit once you pass away.
$144,237	$156,000	Joint Life with 10 year certain. You will receive this income during the lifetimes of both annuitants. If one annuitant passes away you will continue to receive income until the death of the other annuitant. If both annuitants pass away within the first ten years your beneficiaries will receive the remaining income payments until the end of the ten year period (a lump sum death benefit may be available).
$160,860	$312,000	Joint Life with 20 year certain. You will receive this income during the lifetimes of both annuitants. If one annuitant passes away you will continue to receive income until the death of the other annuitant. If both annuitants pass away within the first 20 years your beneficiaries will receive the remaining income payments until the end of the 20 year period (a lump sum death benefit may be available).
$143,762	$143,762	Joint Life with cash refund. You will receive this income during the lifetimes of both annuitants. If one annuitant passes away you will continue to receive income until the death of the other annuitant. If both annuitants pass away your beneficiaries will receive a lump-sum payment of the original investment less income payments made to date.

Analysis

- By using purchasing the Joint Life with 10 year certain, they help litigate the risk when one passes away.
- **Survivorship** - One big assumption here is that both will survive until 2036 (Jack 80 and Jill 75). If one passes earlier there may be some problems making ends meat until the annuity payments begin. On the other hand if both survive until 2036 they will enjoy the benefit of receiving full SS and the annuity payouts until one of them passes.
- **Inflation** – As pointed out in the Gap calculation inflation will continue to eat at the purchasing power of the monthly payments. On the other hand, cost of living for one person should be less than two, but there are also raising medial expenses as one ages, so in the end, this all may be a wash.
- **Inheritance** – By purchasing the Joint Life with 10 year certain they may have the opportunity to pass money to family members if they both pass before 2046 (Jack 90, Jill 85).
- **Taxes** – Currently any income exceeding $32,000 will trigger taxes on social security income in addition to regular taxes due for the annuity income.

Case #2 – Primary Income to SS then supplemental

- Goal: Single Suzie is 54 and plans on retiring next year when she is 55. She has no other source of income except for the retirement funds she has accumulated.
- Single Suzie (54)
- Retirement savings: $1,500,000
- Confortable cost of living: $60,000/year
- Sources of fixed income
  - Social Security at 70yrs old: 38,304/year
- **The Gap**
  - **$60,000**/year for the next 15 years to age 70.
  - $21,696 in today's dollars, **$31,422** by 2037, assuming a 2.5% inflation rate.
- Purchasing two annuities, reflecting the change of income as Social Security kicks in at age 70 is provided below.
- **Remaining funds**: After annuities purchase, Suzie will have **$411,303** for investing in the stock market and to use as play money.

Premium	Payout	Income Annuity Options
$777,387	$900,000	15 Year Period Certain. Receive payment for 15 years starting at 55 and ending at age 70 when SS will kick in.
$311,310	$0	Single Life Only. You will receive this income for life. However, your beneficiaries do not receive a death benefit once you pass away.
~~$332,374~~	~~$314,280~~	~~Single Life with 10 year certain. You will receive this income for life. If you pass away within the first ten years your beneficiaries will receive the remaining income payments until the end of the ten year period (a lump sum death benefit may be available).~~

Analysis

- **Maximize Social Security** – Had Suzie claimed SS at the earliest possible age of 62, her benefits would only be $1,785/month, by waiting until she is 70, she has increased her benefits to$2,570/month, an increase of $785/month, that is a 144 % increase. This is a great return! She would hard pressed to find an investment that promises a guaranteed return at this rate.
- **Inflation** – We have covered the income gap for Social Security so that her income purchasing power will be the same as $60,000 in todays dollars. One gap we have not addressed it the dwindling value of the 15 year annuity she has purchased. At the end of the 15 year period (assuming a 2.5% inflation rate), that $60,000 yearly payout will be with only $41,282 in todays dollars. Suzie should consider either purchasing an inflation rider to address this, or anticipate using some of her retirement funds to fill the gap. On the other hand, is isn't unrealistic to expect that the $411,300 she has for investment may outpace inflation by something like 2.5%/year, over the 15 year period providing her with an extra $10,282/year that just might keep up with the decreasing purchasing power of her annuity.
- **Inheritance** – The any time remaining in the initial 15 year Period Certain plan can go to a designated beneficiary. However Single Life only plan selected will not have any benefits for a beneficiary, Suzie could spend an extra $21,064 and bump up to a 10 year certain plan if she wants to.
- **Taxes** – Currently any income exceeding $25,000 for a single tax payer will trigger taxes on social security income in addition to regular taxes due for the annuity income.

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Case #3 – Portfolio Stability and Income

- Moneybags Martha (60)
- Goal: Moneybags Martha has accumulated 3,500,000 for her retirement. She is ready to retire. She is planning on waiting until she is 70 to start collecting Social Security so she can maximize the payout. She will also need to purchase he own Health insurance until she is eligible for Medicare at 65 and expects this will cost about $25,000/year. She is confident she should have enough money to retire in comfort, but is worried about the market gyrations impacting her savings as the market dips and rises
- Retirement savings: $3,500,000
- Confortable cost of living: $60,000/year + 25,000 for insurance = $85,000
- At age 70 $70,000 in todays dollars (living $60,000 plus $10,000 medical expenses not covered by medicare)
- Sources of fixed income
  - Social Security at 70yrs old: 41,850/year
- Other sources of income
  - Dividends from her investments are currently returning about $70,000/year. For safety sake she wants to assume a conservative $50,000/year in investment income.
- **The Gap**
  - **$45,000**/year for the next 10 years to age 70.
  - At 70 the gap is $45,000 in todays dollars, $**57,604** at age 70, assuming a 2.5% inflation rate.
- Purchase **$600,000 Fixed Index Annuity** and withdrawing $60,000/year eliminates risk, (10% of annuity value may be allowed without penalty) and allows for some market participation depending on the plan she uses (Cap, Spread, ParticipationRate).
- **Remaining funds**: TBD

Premium	Payout	Income Annuity Options
$600,000	*N/A	In this situation 10% ($60,000) of annuity is to be withdrawn for the next 10 years, ensuring no loss in value but ability to partially participate in market gains, likely performing better than purchasing bonds performance.

Analysis

- **Maximize Social Security** – By waiting until she is 70 years old Martha is gaining 5-8% gain/year with no risk.
- **Inflation** – While a regular fixed annuity would loose value as time goes by, the Fixed Index Annuity has the possibility of tracking or possibly passing inflation in value as time proceeds.
- **Inheritance** – While loosing control of her initial investment at first she will eventually get all her money back and after a fixed period (typically 6-8years) will have the ability to retrieve the remaining funds in her annuity if she so desires.
- **Taxes** – Fixed Index Annuities share many common characteristics with IRA's and 401k's. There are penalties associated with withdraws before the age of 59 ½ and withdraws are generally taxed at the taxpayers tax bracket rate.
- **Stability and Income** – Here Martha is utilizing the annuity as a regular source of income, and removing the risk of loss from the market. But will be restricted on how much of the market gains she will be able to participate in. Martha may want to consider purchasing more Fixed Income Annuities (laddering) as time

proceeds to complement bond purchases that would typically be used to minimize losses due to market downturns.

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