

Subject: Insurance - Annuities

Last-Revised: 20 Jan 2003

Contributed-By: Barry Perlman, Chris Lott ([contact me](#)), Ed Zollars (ezollar at mindspring.com)

An annuity is an investment vehicle sold primarily by insurance companies. Every annuity has two basic properties: whether the payout is immediate or deferred, and whether the investment type is fixed or variable. An annuity with immediate payout begins payments to the investor immediately, whereas the deferred payout means that the investor will receive payments at a later date. An annuity with a fixed investment type offer a guaranteed return on investment by investing in government bonds and other low-risk securities, whereas a variable investment type means that the return on the annuity investment will depend on performance of the funds (called sub-accounts) where the money is invested. Based on these two properties with two possibilities each, there are four possible combinations, but the ones commonly seen in practice are an annuity with immediate payout and fixed investments (often known as a fixed annuity), and an annuity with deferred payout and variable investments

(usually called a variable annuity). This article discusses fixed annuities briefly and variable annuities at some length, and includes a list of sources for additional information about annuities.

Fixed Annuities

The idea of a fixed annuity is that you give a sum of money to an insurance company, and in exchange they promise to pay you a fixed monthly amount for a certain period of time, either a fixed period or for your lifetime (the concept of 'annuitization'). So essentially you are converting a lump sum into an income stream. Whether you choose period-certain or annuitization, the payment does not change, even to account for inflation.

If a fixed-period is chosen (also called a period-certain annuity), the annuity continues to pay until that period is reached, either to the original investor or to the investor's estate or heirs. Alternatively, if the investor chooses to annuitize, then payments continue for a variable period; namely until the investor's death. For an investor who annuitized, the insurance company pays nothing further after the investor's death to the estate or heirs (neither principal nor monthly payments), no matter how many (or how few) monthly payments you received.

Fixed annuities allow you some access to your investment; for example, you can choose to withdraw interest or (depending on the company etc.) up to 10% of the principal annually. An annuity may also have various hardship clauses that allow you to withdraw the investment with no surrender charge in certain situations (read the fine print). When considering a fixed annuity, compare the annuity with

a ladder of high-grade bonds that allow you to keep your principal with minimal restrictions on accessing your money.

Annuitization can work well for a long-lived retiree. In fact, a fixed annuity can be thought of as a kind of reverse life insurance policy. Of course a life insurance contract offers protection against premature death, whereas the annuity contract offers protection for someone who fears out-living a lump sum that they have accumulated. So when considering annuities, you might want to remember one of the original needs that annuities were created to address, namely to offer protection against longevity.

Another situation in which a fixed annuity might have advantages is if you wish to generate monthly income and are extremely worried about someone being able to steal your capital away from you (or steal someone's capital away from them). If this is the case, for whatever reason, then giving the capital to an insurance company for management might be attractive. Of course a decent trust and trustee could probably do as well.

Variable Annuities

A variable annuity is essentially an insurance contract joined at the hip with an investment product. Annuities function as tax-deferred savings vehicles with insurance-like properties; they use an insurance policy to provide the tax deferral. The insurance contract and investment product combine to offer the following features:

1. Tax deferral on earnings.
2. Ability to name beneficiaries to receive the balance remaining in the account on death.
3. "Annuitization"--that is, the ability to receive payments for life based on your life expectancy.
4. The guarantees provided in the insurance component.

A variable annuity invests in stocks or bonds, has no predetermined rate of return, and offers a possibly higher rate of return when compared to a fixed annuity. The remainder of this article focuses on variable annuities.

A variable annuity is an investment vehicle designed for retirement savings. You may think of it as a wrapper around an underlying investment, typically in a very restricted set of mutual funds. The main selling point of a variable annuity is that the underlying investments grow tax-deferred, as in an IRA. This means that any gains (appreciation, interest, etc.) from the annuity are not taxed until money is withdrawn. The other main selling point is that when you retire, you can choose to have the annuity pay you an income ("annuitization"), based on how well the underlying investment performed, for as long as you live. The insurance portion of the annuity also may provide certain investment guarantees, such as

guaranteeing that the full principal (amount originally contributed to the account) will be paid out on the death of the account holder, even if the market value was low at that time.

Unlike a conventional IRA, the money you put into an annuity is not deductible from your taxes. And also unlike an IRA, you may put as much money into an annuity as you wish.

A variable annuity is especially attractive to a person who makes lots of money and is trying, perhaps late in the game, to save aggressively for retirement. Most experts agree that young people should fully fund IRA plans and any company 401(k) plans before turning to variable annuities.

Should you buy an annuity?

The basic question to be answered by someone considering this investment is whether the cost of the insurance coverage is justified for the benefits that are paid. In general, the answer to that question is one that only a specific individual can answer based on his or her specific circumstances. Either a 'yes' or 'no' answer is possible, and there may be much support for either position. People who oppose use of annuities will point out that it is unlikely (less than 50% probability) that the insurance guarantees will pay off, so that the guarantees are expected to reduce the overall return. People who favor use of annuities tend to suggest that not buying the guarantees is always an irresponsible step because the purchaser increases risk. Both positions can be supported. But the key issue is whether the purchaser is making an *informed* decision on the matter.

Now it's time for some cautionary words about the purchase of annuities. Many experts feel that annuities are a poor choice for most people when examined in close detail. The following discussion compares an annuity to an index fund (see also the article on [index funds](#) elsewhere in this FAQ).

Variable annuities are extremely profitable for the companies that sell them (which accounts for their popularity among sales people), but are a terrible choice for most people. Most people are much better off in an equity index fund. Index funds are extremely tax efficient and provide, overall, a much more favorable tax situation than an annuity.

The growth of an annuity is fully taxable as income, both to you and your heirs. The growth of an index fund is taxable as capital gains to you (which is good because capital gains taxes are always lower than ordinary income) and subject to *zero* income tax to your heirs. This last point is because upon inheritance the asset gets a "stepped up basis." In plain English, the IRS treats the index fund as though your heirs just bought it at the value it had when you died. This is a major tax advantage if you care about leaving your wealth behind. (By contrast the IRS

treats the annuity as though your heirs just earned it; they must now pay income tax on it!)

If you remove some money from the index fund, the cost basis may be the cost of your most recent purchase (or if the law is changed as the administration currently recommends, the average cost of your index investments). By contrast, any money you remove from an annuity is taxed at 100% of its value until you bring the annuity's value down to the size of what you put in. (The law is more favorable for annuities purchased before 1982, but that's another can of worms.)

Tax considerations aside, the index fund is a better investment. Try to find some annuities that outperformed the S&P 500 index over the past ten or twenty years. Now, do you think you can pick which one(s) will outperform the index over the *next* twenty years? I don't.

Annuities usually have a sales load, usually have very high expenses, and *always* have a charge for mortality insurance. The expenses can run to 2% or more annually, a much higher load than what an index fund charges (frequently less than 0.5%). The insurance is virtually worthless because it only pays if your investment goes down AND you die before you "annuitize". (More about that further on.) Simple term insurance is cheaper and better if you need life insurance.

Annuities often invest in funds that are difficult to analyze because independent reports such as Morningstar are not available. However, you may find insurance companies that use portfolios for which Morningstar reports are available, which will help with analysis of their annuity contracts.

Annuity contracts are very difficult for the average investor to read and understand. Personally, I don't believe anyone should sign a contract they don't understand.

Annuities offer the choice of a guaranteed income for life. If you choose to annuitize your contract (meaning take the guaranteed income for life), two things happen. One is that you sacrifice your principal. When you die you leave zero to your heirs. If you want to take cash out for any reason, you can't. It isn't yours anymore.

In exchange for giving all your money to the insurance company, they promise to pay you a certain amount (either fixed or tied to investment performance) for as long as you live. The problem is that the amount they pay you is small. The very small payoff from annuitizing is the reason that almost no one actually does it. If you're considering an annuity, ask the insurance company what percentage of customers ever annuitize. Ask what the payoff is if you annuitize and you'll see why. Compare their payoff to keeping your principal and putting it into a ladder of U.S. Treasuries, or even tax-free munis. Better yet, compare the payoff to a

mortgage for the duration of your expected lifespan. If you expect to live to 85, compare the payoff at age 70 to a 15-year mortgage (with you as the lender).

For a fixed payout you would be better off putting your money into US Treasuries and collecting the interest (and keeping the principal).

Now let's consider a variable payout, determined by the performance of your chosen investments. The problem here is the Assumed Interest Rate (AIR), typically three or four percent. In plain English, the insurance company skims off the first three to four percent of the growth of your investments. They call that the AIR. Your monthly distribution only grows to the extent that your investment grows MORE than the AIR. So if your investment doesn't grow, your monthly payment shrinks (by the AIR). If your investment grows by the AIR, your monthly payment stays the same. When the market has a down year, your monthly payment shrinks by the market loss plus the AIR.

If you do decide to go with an annuity, buy one from a mutual fund company like T. Rowe Price or Vanguard. They have far superior products to the annuities offered by insurance companies.

Annuities in IRAs?

Occasionally the question comes up about whether it makes sense to buy a variable annuity inside a tax-deferred plan like an IRA. Please refer to the list of four features provided by annuities that appears at the top of this article.

The first, income deferral, is utterly irrelevant if the annuity is held in an IRA or retirement account. The IRA and plan already provides for the deferral and, in fact, distributions are governed by the provisions of Section 72 applicable to IRA retirement plans, not the general annuity provisions. I would go so far as to tell anyone who has someone trying to sell them one of these products in a plan based on the tax benefits to **run** as fast as possible away from that adviser. S/he is either very misinformed or very dishonest.

The second, beneficiary designation, is also a nonissue for annuities in a retirement account. IRAs and qualified plans already provide for beneficiary designations outside of probate, for better or worse.

The third, annuitization, is potentially valid, since that is one method to convert the IRA or plan balance to an income stream. Of course, nothing prevents you from simply purchasing an annuity at the time you desire the payout rather than buying a product today that gives you the option in the future.

I suppose it is possible that the options in the product you buy today may be superior to those that you expect would be available on the open market at the

time you would decide to "lock it in" or you may at least feel more comfortable having some of these provisions locked in.

Finally, the fourth feature involves the actual guarantees that are provided in the annuity contract. To take care of an obvious point first: the guarantees are provided by the insurance carrier, so clearly it's not the level of FDIC insurance that is backed by the US Government. But, then again, only deposits in banks are backed by this guarantee, and the annuity guarantees have generally been good when called upon.

Normally, any guarantee comes at some cost (well, at least if the insurer plans to stay in business [grin]) and the cost should be expected to rise as the guarantee becomes more likely to be invoked. Some annuities are structured to be low cost, and tend to provide a bare minimum of guarantees. These products are set up this way to essentially, provide the insurance "wrapper" to give the tax deferral.

I would note that if, in fact, the guarantees are highly unlikely to be triggered and/or would only be triggered in cases where the holder doesn't care, then any cost is likely "excessive" when the guarantee no longer buys tax deferral, as would be the case if held in a qualified plan. Note that the "doesn't care" case may be true if the guarantee only comes into play at the death of the account holder, but the holder is primarily interested in the investment to fund consumption during retirement.

What this means is that you need a) a full and complete understanding of exactly what promise has been made to you by the guarantees in the contract and b) a full understanding of the costs and fees involved, so that you can make a rational decision about whether the guarantees are worth the amount you are paying for them.

It's theoretically possible to find a guarantee that would fit a client's circumstance at a cost the client would deem reasonable that would make the annuity a "good fit" in a retirement plan. Some problems that arise are when clients are led to believe that somehow the annuity in the retirement plan gives them a "better" tax deferral or somehow creates a situation where they "avoid probate" on the plan. A good agent is going to specifically discuss the annuitization and investment guarantee features when considering an annuity in a plan or IRA and will explicitly note that the first two (tax deferral and beneficiary designation) don't apply because it's in the plan or IRA.

Articles about annuities

1. Tracy Byrnes discussed annuity fees in an article that appeared on TheStreet.com on 29 July 05.
<http://www.thestreet.com/funds/investorforum/10235461.html>

2. Scott Burns published an article "Why variable annuities are no match for index funds" at MSN Money Central on 15 June 2001.
<http://moneycentral.msn.com/articles/invest/extra/7272.asp>
3. Mark Ingebretsen rated annuity comparison-shopping sites in an article that appeared on TheStreet.com on 5 May 00. Also look for the links to two articles by Vern Hayden with arguments for and against variable annuities.
<http://www.thestreet.com/funds/toolsofthetrade/934103.html>
4. An article "Annuities: Just Say No" appeared in the July/August 1996 issue of Worth magazine.
5. A writeup entitled "Five Sad Variable Annuity Facts Your Salesman Won't Tell You" was published in the April 5, 1995 Wall Street Journal quarterly review of mutual funds.

Annuity websites

1. Raymond James offers a free and independent resource with comprehensive information about annuities.
<http://www.annuityfyi.com/>
2. Client Preservation & Marketing, Inc. operates a web site with in-depth information about fixed annuities.
<http://www.fixedannuity.com/>
3. Cornerstone Financial Products offers a site with complete information about variable annuities, including quotes, performance, and policy costs.
<http://www.variableannuityonline.com/>
4. WebAnnuities.com helps investors choose annuities with instant quotes and an annuity shopper's library that has extensive information about annuities.
<http://www.immediateannuities.com/>