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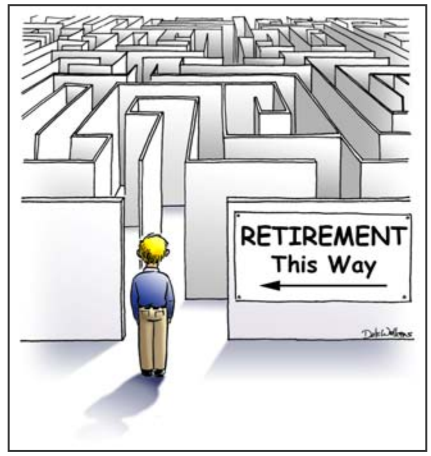
Annuities: Know What You're Buying

Navigating the Retirement Maze



With the stomach-churning gyrations of the stock market last month and memories of 2008 still fresh in the minds of investors, insurance salesman are out in force with annuity pitches. Annuities, which are basically a promise by an insurance company to pay income for life, can be an appropriate investment for some individuals, depending upon their retirement savings, income needs, age, expected longevity, and risk tolerance. Think of annuities as a supplement to the annuity-like payments of Social Security and pensions.

Annuities have some tax deferral advantages similar to those of IRAs, and most include a death benefit as part of the policy. However, all annuities aren't the same, and comparing the alternatives can be confusing. Further complicating the picture are the various options ("riders") which provide additional benefits, but at a price. Annuities also lock up your principal, and the various fees charged can significantly reduce your income. However, if your angst about owning stocks and bonds is sufficiently high such that you prefer a more predictable income stream, then you should consider annuities.

Types of Annuities

Annuities come in three basic "flavors":

- Fixed annuities –This is the "vanilla" option: You give money to an insurance company, and they promise to give you a specific payment each year for as long as you live. Because of their simplicity, they are the easiest ones to compare among insurers. You can often add inflation protection to the annual payouts, but it will cost extra and be capped.
- Variable annuities – By investing in mutual funds rather than fixed income investments, VAs provide some upside growth potential. However, fees can reduce the fund returns considerably. Plus, you've introduced market risk into your return, and the choices of funds in which to invest are up to you.
- Index annuities – IAs are pitched as giving you the upside of the stock market coupled with protection of your principal. However, the upside has "performance caps" that limit your market gains, and the fees tend to run higher than those for fixed annuities.

Another variant on annuities is that they can be either immediate – payouts start within one year – or deferred, where payouts begin at a specified future date. The latter is often called "longevity insurance." Which one you choose will depend upon when you will need the income.

Understand the Fees

For starters, you should be aware that the annuity salesperson gets a substantial fee, usually from 4 to 10 percent of the total. Because of this and other sales-related expenses, there is a high price to pay if you want to cancel the policy: typically starting at 7 percent of the amount invested, gradually declining for periods of up to 10 years.

Then there are the annual fees associated with the annuity itself. These include:

- Administrative – To cover sales compensation and managing the annuity contract.
- Mortality and expense risk – Pays for death benefits and annuity payout risk.
- Underlying fund expenses (for VAs) – Similar to the expense fee on mutual funds.
- Optional riders – For guaranteed minimum benefits, principal protection, etc.

Other Options for the Risk-Averse

Any "guarantee" comes at a price, and this is especially true for annuities. By the time you factor in all of the fees associated with an annuity, you can often do much better with a well constructed portfolio of bonds, mutual funds, and ETFs that is designed to meet your long-term income needs and risk tolerance. While not guaranteed, they have been shown by many studies to outperform annuities a high percentage of the time.

Annuities are complex products. While I tend to favor the "vanilla" version (i.e., fixed) for our clients who could benefit from purchasing annuities, and ones sold by "fee only" advisors who don't receive a commission on the sale, some individuals may feel that they need VAs or IAs. If so, then make sure that you understand all of the features, fees, options (and their costs), and limitations of an annuity before committing a substantial portion of your retirements savings to one. FINRA (www.finra.org/Investors/ProtectYourself) provides reliable information on annuities, and other Web sites can help evaluate the various annuities available.

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