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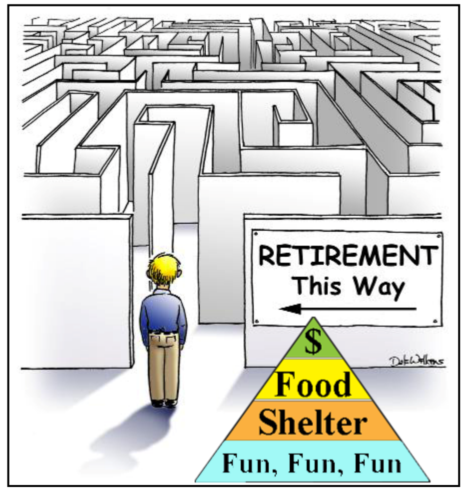
Annuities redux: Needs and wants

Navigating the Retirement Maze



If you open the pages of any major newspaper these days, you're likely to see ads with Ken Fisher staring at you, stating: "I HATE annuities. And you should, too." (His disdain may come from the fact that annuities deprive him of clients, who he charges 1 percent or more annually to manage their assets.)

Since I first wrote about annuities (September 2011), I've come to appreciate what I call "appropriate annuities." In certain cases, annuities serve a valuable function, which is to provide a guaranteed income stream to help pay for retirement necessities. Annuities are essentially "longevity insurance," addressing the risk of running out of money if you live to a ripe old age.

When prospective clients visit my office and I review their investment portfolios, I often find what I consider "inappropriate annuities": high fees, high surrender penalties, inappropriate investments and rider options, and a poor fit for that client's situation. So who should use annuities, and which types work best for them?

Needs versus wants

When planning for retirement, you should divide your expenses into needs and wants. Needs are those things without which you would have a difficult time surviving: food, clothing, shelter, etc. Wants are desirable, but their absence is not life-limiting, as in: "I want a vacation house on a lake." "I want to travel around the world." Clearly, needs outrank wants on Maslow's hierarchy.

You want to make sure that your needs are paid for throughout your retirement. This is where annuities come in. Nearly everyone already has one annuity that they've been paying into their entire career, called Social Security. To protect against the vagaries of the stock market, an additional annuity can provide one more layer of income to cover your retirement needs.

Keep it simple: Go with vanilla

In my previous article, I discussed the three basic types of annuities: fixed, variable, and indexed. There are also variations on these, many of which manage to further muddy the waters on exactly what you are paying for. I'll briefly review the basic ones, and my thoughts about each as a “need” supplement:

- Variable annuities (VA) -- With VAs, you select mutual funds or portfolios of funds, and thus roll the dice with whatever the markets bring for your particular choices. Many policies offer riders that guarantee a floor on your account balance, but they aren't cheap, often costing an additional 1.5% or more per year. When you total up this and all of the other fees in VAs, you begin to wonder how you'll ever see any gains on your assets. High fees, plus market volatility, are good reasons to skip VAs.

info@CoromandelWM.com Phone: 781.728.9001

- Indexed annuities (IAs) -- These are touted as the best of both worlds: a guaranteed minimum growth rate, plus participation in the stock market. I have several issues with IAs. First, the minimum rate is presently quite low, so it's not much of a guarantee. Second, your upside is limited by the formulas that the policy uses to calculate your return, meaning that you only get a fraction of any market gains. Finally, you are asked to choose the formula that you would like to use for market participation. Unless you are a math whiz, you have no idea which one is best, so most people go with whatever the agent recommends. Pass on these as well.
- Fixed annuities (FAs) -- The simplest annuity, which is why they're my favorite. No uncertainties about the payout, as it's guaranteed in your contract. The only downside is that the current low interest rates put a cap on the minimum return of these policies. This can be addressed by "laddered annuities": purchase one every few years as interest rates change. Another issue is that inflation diminishes the buying power of your payouts over time. However, there are inflation protection riders available, or you can do your own calculation to ensure that your payouts later in life will be sufficient to cover your needs.

Stretch your dollars

In order to get the most income for your policy cost, consider two approaches. First, while FAs can be purchased to provide immediate payouts, called immediate annuities (IAs), you'll get higher monthly payouts per dollar invested if you purchase a deferred annuity (DA). A DA starts paying out at a specific date in the future, so you can get one to coincide with your retirement, or the age at which you think you'll need the kicker of extra income. The longer the delay, the higher the payouts.

Second, FAs are straightforward enough that they often can be purchased without the need of an agent. Fidelity and Vanguard both offer low-cost FAs that can be purchased on-line, with calculators to help figure out the best policy for you. Want to sweeten the deal by getting all of your annuity distributions tax-free? Purchase it inside of a Roth IRA.

Annuities represent one option for how to finance your retirement. When used properly, they can complement your other sources of retirement income and provide you with peace of mind at a reasonable cost.

George Gagliardi is a fee-only financial advisor with Coromandel Wealth Management in Lexington, where he helps clients develop and implement investment and retirement strategies. He can be reached at (781) 728-9001 or george@CoromandelWM.com. George is affiliated with Trust Advisory Group, Ltd., a Registered Investment Advisor. This article is intended for general information purposes only, and may not be appropriate for your specific circumstances. Investment advice is particular to each individual, and should only be given after an individual situation has been reviewed.