ANNUITIES

THE GOOD THE BAD AND THE UGLY

One of the least understood financial products ever designed is called an **annuity**. There are people who love them and people who hate them. So why are there so many extreme opinions when it comes to annuities? In this brief summary, we will address **the good, the bad, and the ugly.**

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You may hear people on the TV and radio touting these products as the best financial product ever designed. But then the next so-called financial expert trashes them, saying they are the worst.

Perhaps lumping all annuities into one category, either good or bad, is the wrong approach. It would be like saying that ALL mutual funds are good or that ALL mutual funds are bad.

The truth is, some mutual funds are much better than others and some are horrible. Just like stocks, there are some companies that are much better than others, and not all stocks or mutual funds are appropriate for every investor.

Blanket statements are often very biased. Having investments that align with your risks and goals is the most prudent approach. You have to use the right tool for the job.

First, **The Good:**
Annuities grow **tax-deferred** and can provide a **safe place** for your money to grow at rates normally higher than many bank accounts.

The Bad:
Annuities have **surrender fees**. They are **longer term** products and should not be used as short-term savings accounts. Make sure that before putting money into an annuity that you have OTHER monies available for short-term needs.

The Ugly:
Some annuities have huge **fees** and some pass along **market risks** to the investor. Some companies are notorious for showing higher returns on paper but delivering **less than stellar returns**. Not all annuities are created equal.

"HAVING INVESTMENTS THAT **ALIGN** WITH YOUR **RISKS** AND **GOALS** IS THE MOST PRUDENT APPROACH. YOU HAVE TO USE THE RIGHT TOOL FOR THE JOB."

That said, let's look at how annuities work and see if they might be appropriate for you.

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An **annuity** is a contract between **you** - the investor - and an **insurance company**. The insurance company agrees to hold your money for you until you want it back and then returns it to you as either a **lump sum** or as an **income stream**. This income can be for a certain **period of time** and/or can be over your **lifetime**.

There are a number of different types of annuities and some are much better than others. We will look at four types of annuities:

- **Immediate Annuity**
- **Fixed Interest Annuity**
- **Fixed Indexed Annuity (a.k.a. Equity Indexed Annuity)**
- **Variable Annuity**

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IMMEDIATE ANNUITY

This annuity is purchased with a lump sum deposit. In exchange, the insurance company pays a guaranteed income that starts almost immediately.

This income is paid out for a specific time period (i.e. 5, 10, 15 years, or a lifetime). The lifetime income option has often been described as a private pension account.

Who would want to own such an account?

- Those who are averse to stock market risks
- Those who don't have a pension and want to make certain that their income will last as long as they and their spouse lives.

If you are considering this type of annuity, make certain that you include a period certain or cash refund option to ensure that you and or your heirs will get all of your money back. Do NOT just set up an account that pays out for your lifetime only, because if you die, the income stops and the insurance company keeps the money. Talk with a professional who can set this up correctly for you and your heirs.

The Good:
Income can be **guaranteed for life** and there may be some **tax advantages**.

The Bad:
Once you set up this type of account, you **no longer have access to your original deposit**. The insurance company owns the money and you own the income stream.

The Ugly:
If not set up properly, you could **lose a lot of your money** should you die soon.

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FIXED INTEREST ANNUITY

This type of annuity pays a fixed interest rate over a specific period of time, much like a bank CD.

For example, if you want to invest your money for just five years, the account will pay a fixed specific interest rate for the same five years. At the end of the five years, you can take your money out or renew it for another period of time. The money does grow tax deferred while in the account.

The Good:
You know your **rate of return upfront**.

The Bad:
If you need all of your money before the time period, there are normally **surrender fees**.

The Ugly:
It is **not as liquid** as a bank money market account.

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FIXED INDEXED ANNUITY (EQUITY INDEXED ANNUITY)

This annuity pays a rate-of-return based upon an outside index such as the S&P 500 index. Keep in mind that none of your money is invested in the stock market; your rate of return or interest calculation is based upon performance of an index. If the index goes up, your interest credited can go up. If the market or index crashes, these accounts don't go down. Your upside potential is limited by how the index performs and how the insurance company calculates your return. Most of these accounts will have a cap or maximum that is paid into your account each year.

There are many moving parts to this annuity. Some companies have great caps and rates; others are lackluster. Some companies are notorious for having rates that are very attractive upfront, but then upon each anniversary, they drop their caps and rates. You really need to look at the company renewal history and avoid those companies with poor renewal histories.

These accounts have long-term surrender fees. Make sure you consult with a knowledgeable advisor before putting money into one of these accounts. Don't get trapped into a bad product with long-term high surrender fees.

The Good:

These annuities **go up** when the **markets go up** and **do not lose money** when the market crashes.

The Bad:

Long-term **surrender fees.**

The Ugly:

These accounts are **NOT designed to outperform the stock market**. They are designed to be somewhere between what banks pay and the equity markets. They have beat the markets during some time periods, but that is the exception, not the rule.

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VARIABLE ANNUITY

This is an annuity contract combined with mutual funds or a separate sub-account managed by a mutual fund company. Your account can go up with the markets but it can also go DOWN.

Variable annuities are heavily laden with HUGE fees. You have to pay fees to an insurance company and a mutual fund company. It is not uncommon for all of the fees to add up to 3% to 4% per year. That is quite a deep hole to dig out of before you make a dime every single year. Too many hands in the pie, thus the high fees. The returns are often lackluster compared to a mutual fund.

If you want to invest in the stock market and can tolerate market volatility risk, buy a mutual fund or low-cost ETF.

Why risk losing money in a variable annuity with all the added fees when you can pay much less using a mutual fund or ETF?

The Good:
Not much good here.

The Bad:
A lot of fees.

The Ugly:
FEES, FEES, FEES!

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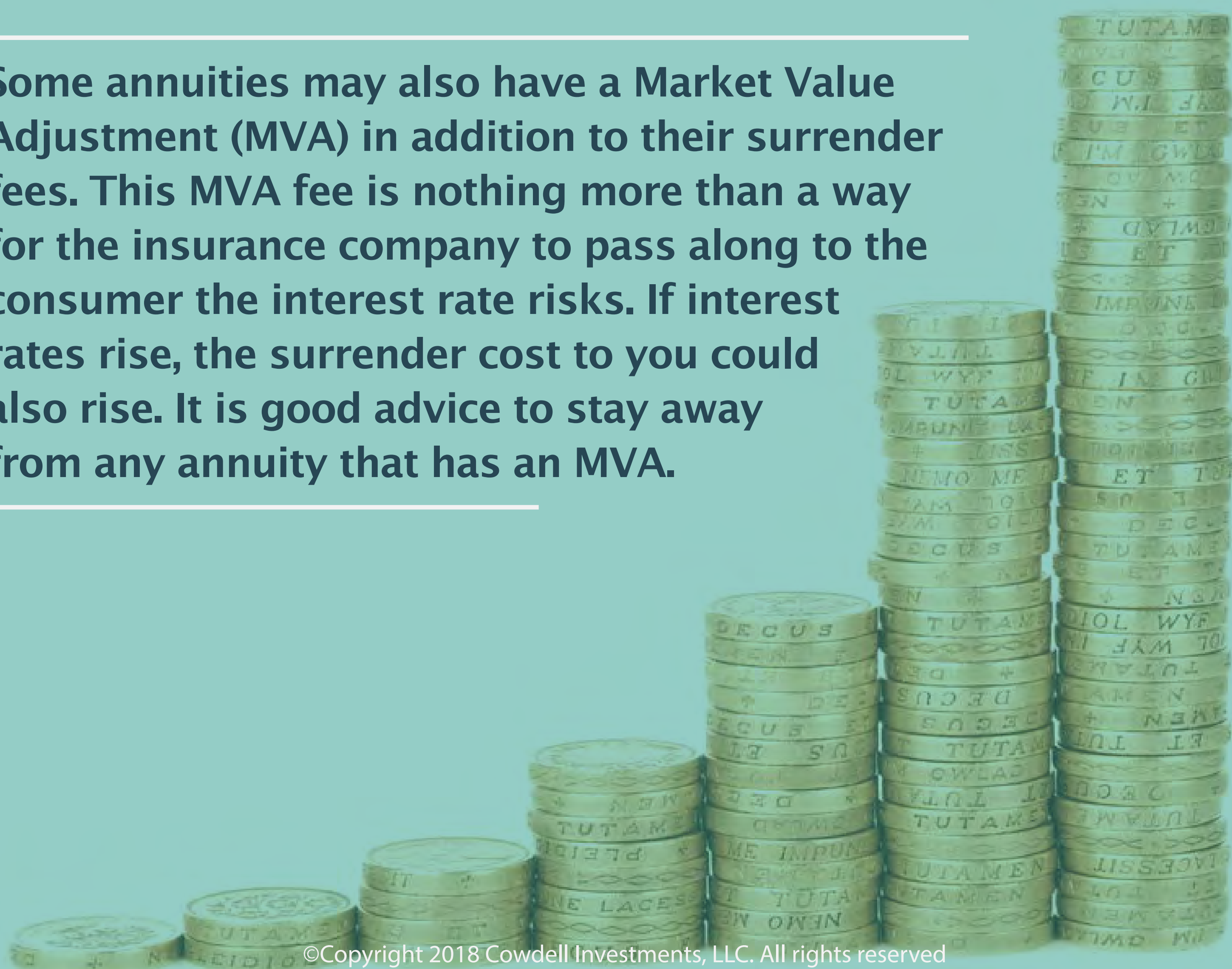
MOST ANNUITIES...

- Grow tax-deferred
- Have surrender fees for a specific period of time; 5 to 10 years…
- Allow for interest to be withdrawn without any penalties…
- Allow for penalty-free withdrawals of 10% per year…
- Will waive surrender fees for death, long-term hospitalization, and other hardships...

Every annuity is unique, even though they may have some general features.



Some annuities may also have a Market Value Adjustment (MVA) in addition to their surrender fees. This MVA fee is nothing more than a way for the insurance company to pass along to the consumer the interest rate risks. If interest rates rise, the surrender cost to you could also rise. It is good advice to stay away from any annuity that has an MVA.

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BOTTOM LINE...

Some annuities are good, some are bad, and some are ugly.

Annuities are a financial tool. Like all other financial tools, you need to use them correctly if you want the intended benefits.

If you want safety, income guaranteed for your lifetime, and have other liquid cash, annuities might be a good fit.

If on the other hand you can tolerate market fluctuations, you want to beat the markets and want lower fees, invest in ETFs or exchange Traded Funds.

Perhaps a combination of both would be a good fit for your situation. Set clearly defined goals of what you are trying to accomplish.

Talk with a knowledgeable financial advisor or CFP to chart a successful financial future.

Feel free to contact us and speak with one of our Certified Financial Planner professionals

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