Titanium Advisors, LLC
Financial Planning + Investment Management

TOO GOOD TO BE TRUE?

Why Variable and Index Annuities Are Poor Investments for Most People

The driving force behind the purchase of most annuities is a guaranteed lifetime income feature which appears to offer the investor investment returns equal to the greater of a minimum interest rate (usually 5% to 7% per year) or the gains generated by the underlying stock market investments. While these annuity policies come in many forms, they usually are sold by showing the customer a glossy brochure with a graph demonstrating that the purchaser cannot lose regardless of whether the stock market goes up or down.

The notion of enjoying stock market gains without the corresponding downside risk is a powerful emotional incentive to purchase the annuity. Also, the "advisor" who is selling the policy will be paid a large commission (5% to 7% typically) and so has a significant financial incentive for the sale to occur.

Unfortunately, as with most things in life that seem too good to be true, there is a "catch" hidden in the fine print which changes matters considerably. Buried within the 50+ page contract, there are numerous fees, restrictions, and penalties which take away most of the benefits the investor believes the annuity would provide. Most investors simply rely upon what the salesperson tells them—which is, at best, only part of the story.

We estimate that over 90% of all annuity holders would not have purchased the policy if they had known all the facts, particularly the terms and conditions hidden in the annuity contract. Important factors to consider include the following:

• **Annual Fees and Expenses**. Annuities charge significant annual fees and expenses for the policy and the related sub-accounts (typically between 3% and 3½% of the account balance per year). These charges apply regardless of whether the stock market goes up or down and come directly out of the investor's account balance.

• **Surrender Fees**. Annuities impose steep early withdrawal charges (called "surrender fees") if you need to withdraw more than 10% of your investment within the first 7 to 10 years of the policy. Surrender fees are typically 6% to 8% of the excess distribution during the first two years of the contract and gradually decline each year thereafter. If the policy holder withdraws substantial amounts during this timeframe to pay unexpected expenses from medical bills, family emergencies and the like, the withdrawal penalty could be severe. Also, if investors change their minds and desire to invest the funds elsewhere, the surrender fees make it very difficult to exit the annuity before several years have elapsed.

• **No Excess Payments**. If the investor needs additional income to pay unanticipated expenses after the annuity payments have begun, receiving more than the scheduled monthly payment will usually void the lifetime income guarantee.

• **Guaranteed Income Base**. While prominently displayed in all marketing materials and account statements, the "benefit base" or "income base" which grows at the guaranteed minimum interest rate is not the investor's money and it cannot be withdrawn. Most investors are confused by this and believe that the annuity contract is providing a 5% to 7% minimum guaranteed return on their investments. This is simply not true. The benefit or income base can only be utilized for conversion into a fixed payment annuity from the same insurance company, frequently at an inflated price.

• **No Inflation Protection**. Once an investor begins receiving lifetime payments under the annuity, the benefit or income base is frozen so that all future monthly payments will be for the same fixed amount without any protection against inflation. For example, if the annual inflation rate were 3½% per year, in 20 years these payments would lose over half of their purchasing power.

• **Not Much Income Actually Guaranteed**. For the first 15 to 20 years of lifetime payments, the insurance company is just paying back the investor his or her own money as each payment simply reduces the annuity account balance. The insurance company does not have to reach into its pocket to make the annuity payments unless and until the account balance has been reduced to zero.

• **Increased Income Taxes**. Investment gains from mutual funds held for more than one year are taxed at the lower capital gains rate. However, all gains from investments held in an annuity are taxed at the higher ordinary income tax rate—even if the gains are attributable to long-term mutual fund investment gains. In essence, annuities held outside of a retirement account convert long-term capital gains into higher taxed ordinary income.

• **Will Guarantee Be Honored**? The guarantee of lifetime income provided by annuities is only as good as the financial strength of the life insurance company which issues them. While most companies are reasonably strong today, the guarantee will likely not apply until at least 15 to 20 years from now. It is very difficult to predict the financial strength of any company that far into the future. Also, the exact time the guarantee would have the most value to the investor (i.e., after a major financial crisis or stock market crash) is when it is most likely that the insurance company will be unable to honor the guarantee due to an overwhelming number of similar claims held by other investors.

• **Changing the Rules**. Most index annuity contracts allow the insurance company to unilaterally change the percentage of stock market gains the investor receives from time to time. Accordingly, investment returns can be reduced by the insurance company without the investor's consent.

• **Bonus Credits**. In order to induce investors to purchase an annuity (or rollover an existing annuity into a new policy), insurance companies frequently offer a bonus which adds a certain percentage (typically 10%) to the contact account value. These bonus credits always come with higher fees and/or surrender charges and are usually forfeited if you make withdrawals from the policy within several years from the date of the annuity purchase.

• **No Basis Step-up**. Due to the basis "step-up" provisions of the tax code, unrealized investment gains in mutual funds are eliminated when the account owner dies. As a result, the account owner's heirs will not have to pay any income tax upon inheriting these investments. In contrast, investment holdings in an annuity account do not receive a stepped-up basis and so the heirs of the annuity owner will be subject to ordinary income tax treatment when the funds are distributed to them.

• **Exchanging Annuities**. Over one-third of annuity sales result from the transfer of an existing annuity contract in exchange for a new annuity as permitted by Section 1035 of the tax code. Unfortunately, many investors end up worse off after the exchange as the contract costs and/or surrender fees are usually much higher in the new annuity than under the previous policy. The lure of bonus credits or guaranteed lifetime income are frequently the key factors which lure investors into an annuity exchange. Not coincidently, the "advisor" who recommends the exchange will receive a new commission payment from the insurance company issuing the replacement annuity contract. There are several low-cost annuity alternatives (many without any surrender fees) which should be considered before exchanging into a new annuity contract.

• **Annuities Held in an IRA**. Holding annuities in an IRA or other retirement account is usually a bad idea as the tax advantages of the annuity are wasted inside the IRA. After the surrender fee period has expired, almost every investor would be better off surrendering the annuity and transferring the money tax-free into an IRA account which has far more investment options and much lower fees and costs.

• **No Inheritance**. After annuity payments commence, it is likely that the investor's heirs will receive little or no inheritance from the investment. While the annuity contract will provide a stated death benefit, this amount will usually be reduced by each payment distributed to the investor.

• **Limited "Free Look" Period**. While the terms and conditions of the annuity will have a significant impact upon the benefits afforded to the investor, the insurance company will typically send the actual 50 to 60 page contract only after the annuity has been purchased. The investor will then only have a ten day "free look" period to review the dense legal jargon and decide whether to cancel the purchase. This ten day period is the last chance that investors have to back out of the deal before having their money tied up for the next 7 to 10 years.