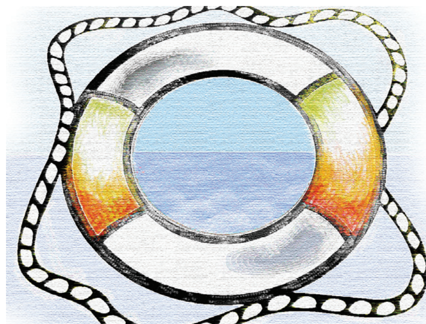
The Costs of Owning an Annuity

By Stan Haithcock

Article Highlights

- All commissions are "built in" to the annuity policy, and an investor never sees the fees deducted from his premium total.
- Deferred annuities come with a surrender charge period and corresponding charges for early withdrawals.
- In order to secure lifetime income, the money allocated to an annuity might miss out on other potential market opportunities.



I think we all can agree that annuities are the curse word of the financial world.

The consensus is that the annuity industry has earned its bad reputation and negative stigma with their maligned sales practices. That being said, over $200 billion of annuities are sold every year with multiple trillions already on the books.

With 10,000 baby boomers retiring each year and needing the types of contractually guaranteed strategies that annuities can provide, it's important to understand all of the costs involved. This is especially the case if you are considering adding an annuity to your portfolio to solve for a specific goal like lifetime income.

Annuities should be viewed as pure "transfer of risk" solutions that solve for a specific need. I have developed an easy-to-remember acronym that will help determine if an annuity would complement your situation. That word is P.I.L.L., which stands for:

P = principal protection
I = income for life
L = legacy
L = long-term care

I think these products should be owned for their contractual guarantees and not potential, hypothetical, or projected growth. The saying I use is "you own an annuity for what it *will do*, not what it *might do*." The point here is that I don't view annuities as growth products, because I think there are much better "non-annuity" alternatives available for growth. Most informed investors agree with me on this.

Cost Categories

Now that we have laid the foundation for where I think annuities should fit within a portfolio, let's look at the specific costs of owning them and also a brief description of each strategy. Annuity costs can be broken down into four categories: disclosed, built-in, opportunity, and tax.

Disclosed Costs

- Within an annuity prospectus (for variable annuities) or statement of understanding (for fixed annuities), annuity companies have to list and explain the specific costs of owning the annuity.
- The annuity agent is responsible to explain these annual costs, how they are applied to the specific annuity contract, and how the policy is affected if money is taken out.
- Riders (attached benefits that can be added to an annuity policy) also come with disclosed costs. Riders can contractually solve for goals like lifetime income, death benefit, or long-term care coverage. It's important to know that the cost of a rider is for the life of the policy. For example, if you have an income rider that has a guaranteed growth percentage during the deferral years, you will still pay an annual fee even if you turn the lifetime income stream on.

Built-In Costs

- Most of the time, these hidden costs involve variable annuity mutual funds (also called separate accounts)

and handshake-type agreements between the carrier and the outside mutual fund companies. This really isn't a big deal here, but you need to know that they exist and do affect your accumulated value investment returns.

- All annuity commissions are built in to the policy, so you never see these fees actually taken out of your premium total. For example, if you invest $100,000 in an annuity, you will see $100,000 applied to your policy. However, it's important to understand that commissions have been paid to the writing agent and those commissions are part of the internal costs of issuing the policy. Don't let your agent get away with saying that they charge no fees. That's simply tiptoeing on the semantic line of truth.
- All deferred annuities (variable, fixed-rate, fixed indexed, etc.) come with a surrender charge period and corresponding surrender charges. For example, if you buy a 10-year fixed indexed annuity, the surrender charges to take all of your money out would be declining in percentage amounts (10, 9, 8, 7, 6, 5, 4, 3, 2, 1, 0). Deferred annuities allow you to take out 10% of the accumulation (investment) value on an annual basis penalty-free, but for any amount over that 10% number, surrender charges will apply.

Opportunity Costs

- This is a cost that most agents never talk about, but needs to be addressed and fully understood before any annuity purchase is made. Because annuities are transfer-of-risk contractually guaranteed solutions, you have to be aware that to solve for a specific goal like lifetime income, the allocated annuity money might miss out on other positive market opportunities outside of the annuity structure. This is why any annuity purchase should be appropriately allocated to fit each specific person's need, and should not be a one-size-fits-all solution.

Tax Costs

- Never take tax advice from anyone other than a qualified tax professional. Always have a real tax professional sign off on all annuity tax strategies.
- For all annuities purchased after 1982, LIFO (last in/first out) taxation applies to money taken out of an annuity contract, with gains being taxed first and at ordinary income tax levels.
- With "annuitized" income streams, the income is a combination of return of principal and interest. For income streams not in a qualified (i.e., IRA) account, an "exclusion ratio" applies. This exclusion ratio is important to understand and plan for, because a portion of your income (return of principal) will not be subject to taxes.
- For annuities in a non-qualified (non-IRA) account, the penalty for taking money out before age 59½ applies, unless the IRS-approved 72T rules for penalty-free withdrawals are implemented correctly. Again, you need a qualified tax professional for all tax strategies using annuities.

Types of Annuities

Let's look at the primary types of commercial annuities available, and the costs attached to each strategy.

Variable Annuities

Costs: The average annual total fee of a deferred variable annuity is around 3% (including attached benefit riders). Ouch! There are also surrender charges as well, if you take the money out before the specified term of the policy.

Key Points: The vast majority of annuities sold in the U.S. are deferred variable annuities with surrender charges, and they tend to pay very high (built in) commissions to the writing agent. Variable annuities were introduced in the 1950s for pure tax-deferred growth, and currently there are some very good no-load/no-surrender-charge variable annuities available. You have to buy them direct from the issuer, but if you can manage your own money, this is an efficient tax-deferred growth alternative to consider. You can also have a registered investment adviser (RIA) or securities licensed adviser manage it for you for whatever fee you negotiate with them. Jefferson National, Vanguard and Fidelity are the best choices in this arena, in my opinion.

Fixed-Rate Annuities

Costs: Fixed-rate annuities work like CDs (certificates of deposit), except that you only pay taxes on the interest when you take the money out. With CDs, you pay taxes on the annual interest if the money is held outside of an IRA. There are no annual fees taken out of a fixed-rate annuity, but there are surrender charges if you take the money out before the specified term.

Key Points: Surrender charge periods can range from as short as two years to up to 10 or more years. Commissions are built in and typically are very low to the writing agent. From an opportunity-cost standpoint, the risk here is locking your money in too long and missing a positive interest rate change. My advice is to look at fixed-rate annuities from three years to no longer than five years in length.

Single-Premium Immediate Annuities

Costs: Single-premium immediate annuities (SPIAs) are the original annuity design (still my personal favorite) and provide a pension like lifetime income stream that efficiently solves for longevity risk. There are no annual fees, but there is also no liquidity. Once the income stream starts, it's on for the duration the contract was set up for—either your life, two lives, a specific period of time or a combination of lifespan and a specific period of time.

Key Points: The opportunity cost with single-premium immediate annuities is locking in rates at what you might think are low levels. Commissions (built in) are the lowest of all commercial annuities. Single-premium immediate annuities are pretty much a direct reflection

Other Considerations When Evaluating an Annuity

Most agents learn one annuity product and try to fit it in to everyone's situation as a one-size-fits-all solution. It goes without saying that this is inappropriate and unsuitable from the consumer's standpoint. Instead of letting an agent launch into telling you about his current favorite annuity, flip the switch and tell that person exactly what you are looking to contractually solve for. In a lot of cases, an annuity is not the solution that you need. In some cases it is, but you need to know everything about the product so you won't be pressured into making a quick and uninformed decision.

In addition to fully understanding how an annuity works and the costs involved, there are a few other key issues that you need to be aware of as well in order to make sure that a specific annuity's contractual guarantees will actually complement your portfolio. The three main topics for discussion with your annuity agent are: current low interest rates, hedge fund annuity ownership, and carrier safety. Let's take a look at each of these issues as final pieces of your annuity decision-making puzzle.

Current Low Interest Rates

A primary pricing mechanism for most annuity products is the 10-year Treasury, which is currently at historically low levels. The single-premium immediate annuity (SPIA) is the annuity product that most reflects the 10-year Treasury. None of us knows where interest rates are going to go (short term or long term), and it is cavalier to say "well, interest rates have to go higher." Ask Japan how that statement went for them over the last two decades. It is a rational thought that interest rates might be at these levels for the foreseeable future. No one really knows, but it is important to plan around your "gut feel" concerning interest rates.

Hedge Fund Carrier Ownership

In less than two years, over 30% of fixed index annuities are now owned by hedge funds and private equity firms like Guggenheim, Apollo, Harbinger, and Athene. The top-selling fixed index annuity in the country in 2012 and currently in 2013 is hedge fund–owned. I'm not sure that this is good or bad, but it's worth knowing about and observing from a due diligence standpoint. These new owners usually pay higher commissions to the writing agent, and offer higher contractual guarantees that most traditional annuity actuaries have trouble signing off on. Let's hope these hedge funds and private equity firms' intentions are long-term and in line with age-old carrier risk management strategies.

Carrier Safety

Annuity guarantees are only as good as the issuing insurance company guaranteeing them. It's very important to do your homework on the safety and stability of the annuity carrier you are considering placing money with. I use the COMDEX scoring system, which is a composite of all rating services. (A complimentary report showing the COMDEX scores is available on my website at (www.stantheannuityman.com/comdex-ratings). COMDEX utilizes the ratings information from Standard & Poor's, Moody's, Fitch, and A.M. Best and assigns a score from 1 to 100, with 100 being the top score. Don't let an agent just refer to one ratings service. Always use COMDEX. Also, you need to know that annuities are regulated at the state level, not the federal level, with each state having a guarantee fund that backs annuity policies to a specific level. I encourage you to see your state's guarantee levels at www.nolhga.com (National Organization of Life and Health Insurance Guaranty Associations).

It can also be helpful to have the agent confirm your perception of the annuity in writing. Rather than accepting his materials, write down exactly how you comprehend the terms and benefits of annuity based on the agent's presentation, sign and date it and then request the agent sign and date the same document.

—*Stan The Annuity Man*

of the 10-year Treasury, so it might make sense to "ladder" your SPIA strategy over time if you don't need all of the needed lifetime income right now. Cost of living adjustment riders (COLAs) can be added to the policy in order to increase the lifetime income on an annual basis by a contractual percentage. However, attaching a COLA to your single-premium immediate annuity will lower your initial payment compared to a SPIA without a cost of living adjustment rider.

Longevity Annuities

Costs: Longevity annuities are in essence a long-term deferred immediate annuity, or what I like to call a deferred pension. There are no annual fees to this strategy, and no real liquidity as well. Deferral periods range from two years to as long as 45 years, with some carriers providing interesting planning strategies from a legacy standpoint.

Key Points: These originally came out about seven years ago, but have just started to become popular within the last two years. Commissions (built in) are very low, but a shade higher than a single-premium immediate annuity. Like

an SPIA, you can contractually attach a cost of living adjustment rider that can increase your lifetime income stream by an annual percentage. As with SPIAs, attaching a COLA to the policy will lower the initial payout amount, so that decision comes down to past life expectancy within your family to determine if a cost of living adjustment rider makes sense. Also, longevity annuities do not have any attachment to the market and the death benefit is typically the initial premium less any payments.

Fixed Index Annuities

Costs: Fixed indexed annuities (FIAs), also called equity-indexed annuities and inappropriately hyped as "hybrids," are fixed annuities with a limited upside (capped) call option on an index like the S&P 500 index. Any gains are locked in to never go below that amount. Costs are minimal, with total fees ranging from 0.50% to 1.50% on average and dependent on the additional riders that are attached to the policy. Most of the current popular offerings come with seven- to 10-year surrender charge periods.

Key Points: A phrase I came up with to remember concerning fixed indexed annuities is "the upside to an FIA is that there is no downside, but the downside to an FIA is that there is very limited upside." Built-in commissions on fixed indexed annuities are very high (as high as or higher than variable annuities), which is a primary reason these are being pushed by your local agent. Opportunity cost needs to be fully understood with this over-hyped and mis-sold product. The average annual return of fixed indexed annuities over the last five years is 3.27%, so this is not a strategy that is going to compete head-to-head with pure market returns even though most agents sell it that way. It's also important to understand that this product was designed to compete with CDs, not the stock market. The 3.27% average return pretty much validates the correct expectations of the product.

Conclusion

No one wakes up in the morning and says, "It's a great day, I think I'm going to buy an annuity." For the most part, annuities are sold, not purchased. That being said, it's important for you to fully understand the costs of an annuity along with other pertinent product facts in order to make an informed decision as to whether these "transfer of risk" strategies make sense for your specific situation. ▲

Stan "The Annuity Man" Haithcock is an annuity specialist and nationally recognized annuity expert. Find out more at www.aaii.com/authors/stan-haithcock. Haithcock will be speaking at the AAII Investor Conference this fall; go to www.aaii.com/conference for more details.

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are funds run by professionals who graduated from top-notch business schools with teams of analysts and access to research, economists and corporate executives.

Compounding matters are common behavioral errors made by investors. Research firm DALBAR calculates that the average return actually realized by mutual fund investors is less than half that of the S&P 500. Blame a combination of buying and selling at the wrong times.

This not to say you can't make money selecting individual stocks. Even Warren Buffett says those who have the time and inclination to select stocks can do well. The key is to approach investing in a disciplined, rational manner with a focus on what research shows has worked over the long term, and not falling for the myths that trip up so many investors.

—*By Charles Rotblut, CFA, Editor,* AAII Journal