Annuities
A Fair and Balanced View

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Introduction

Whether a fan or critic, expert or novice, it is generally agreed that annuities are complex financial instruments whose features, architecture and costs make them among the most difficult to understand. Promoters of annuities naturally portray them as simple and safe investments coupled with valuable guarantees that insure against loss of principal and longevity risk thus providing peace of mind and guaranteed income in retirement. On the other hand, opponents will present elaborate quantitative studies that attempt to demonstrate that annuities are extremely inefficient investments whose "guarantees" come at an unreasonable cost and sacrifice of liquidity.

In addition to the abundance of diametrically opposed expert opinions regarding their worth, confusion surrounding annuities is exacerbated by the fact that they have evolved dramatically in a relatively short period of time.

For instance, Moshe A. Milevsky, Ph.D., a finance professor at the Schulich School of Business at York University in Toronto, arguably one of the most outspoken critics of annuities in the late '90's, essentially reversed his position in 2007.

> **"Regardless of what you want to call these increasingly heterogeneous products, it seems the relative value pendulum has swung in the opposite direction. I can no longer claim that you are being overcharged for these guarantees or that you can achieve similar goals at a lower cost. It would be very difficult and expensive to bake a living benefit in your kitchen."**[1]

On the other hand you have Ken Fisher, a self-proclaimed hater. He is CEO and founder of Fisher Investments and declares "I hate annuities and you should too". In 7 pages of his "Annuity Insights" he maligns the product, outlines the many downsides of investing in annuities and vigorously argues why it is a bad investment. More importantly, Fisher advocates money management for which he charges 1% or more annually. If you are looking for a vitriolic, anti-annuity argument, this may be the piece for you. Just google it but be advised that in order to get your free copy, you need to expose yourself.

Then you have John H. Robinson, owner of Financial Planning Hawaii and Nest Egg Guru, who in an article titled "Annuities hate Ken Fisher and you should too"[2] offers a very contrasting perspective. In a more collegial fashion, Robinson points out the fact that there is a growing body of research and empirical data that supports the value proposition of many of the next gen annuities offering "living benefits" and other secondary guarantees. He also challenges the notion that paying 1% or more to actively manage money adds value relative to a strategy of passively managed index funds.

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[1] Confessions of a VA Critic, Moshe Milevsky, Ph.D. – January 2007 Research Magazine

[2] Article contributed to Advisors Perspective by **John H. Robinson** 4/22/2014

Finally, for their part, regulators like FINRA, SEC and State Commissioners of Insurance and Securities have weighed in with a number of investor publications that are generally intended to highlight the potential risks of investing in annuities and provide guidance to the potential buyer.

http://www.finra.org/investors/alerts/variable-annuities-beyond-hard-sell

http://www.finra.org/investors/alerts/equity-indexed-annuities_a-complex-choice

http://www.sec.gov/investor/pubs/varannty.htm

There is little wonder why the public consumer is as confused while such contradictory messages continue to appear.

A closer look at the design and structure of annuities may be helpful in understanding its place in the broad universe of financial instruments available today. I think there are three relevant questions to ask when choosing any investment and particularly annuities: What is the investment; How does it work; Why use it instead of some alternative.

What Are Annuities

All annuities have a common design center which is to provide the owner/investor with a guaranteed stream of income for a guaranteed period of time. If the income stream begins immediately, it is called a **Single Premium Immediate Annuity (SPIA)** which exchanges a lump sum of money for a guaranteed income stream. If it begins at a later point in time it is called a **Deferred Annuity**. In this respect it is a form of insurance.

Completely the opposite of life insurance, which protects against the economic risk of death, an annuity protects against the economic risk of living too long or, what is referred to as, longevity risk.

How Do They Work

Annuities provide an immediate or future stream of income by utilizing a pool of money created during what is referred to as the **ACCUMULATION PHASE**. The value of that pool is the net of contributions/investments made by the owner, investment performance and fees and expenses. In a classical model, when the owner decides to begin receiving periodic payments the **PAYOUT PHASE** begins by converting the contract to a payout annuity – this is called annuitizing. This conversion is an irrevocable forfeiture of the total accumulated value in exchange for a guaranteed income stream.

If the annuity has “Living Benefit Riders” the owner may receive a periodic income stream without having to annuitize, which may be a distinct advantage. What happens in both the accumulation and payout phases of an annuity depends on features specific to the type of annuity that is used, which we examine below. Before we do that, let’s have a look at what these riders do.

Common Living Benefit Riders in Variable Annuities

Guaranteed Minimum Income Benefit (GMIB)
A guaranteed minimum income benefit rider is designed to provide the investor with a base amount of lifetime income when they retire regardless of how the investments have performed. It guarantees that if the owner decides to annuitize the contract, payments are based on the amount invested, credited with an interest rate--typically 4-5%. An investor must annuitize to receive this benefit and there is typically a seven to ten year wait period before it can be exercised. Age limits may also apply.

Guaranteed Minimum Accumulation Benefit (GMAB)
A guaranteed minimum accumulation benefit rider guarantees that an owner's contract value will be at least equal to a certain minimum percentage (usually 100%) of the amount invested after a specified number of years (typically 7-10 years), regardless of actual investment performance. Typically GMAB’s restrict choices of asset allocation.

Guaranteed Minimum Withdrawal Benefit (GMWB)
A guaranteed minimum withdrawal benefit rider guarantees that a certain percentage (usually 5-7%) of the amount invested can be withdrawn annually until the entire amount is completely recovered, regardless of market performance. If the underlying investments perform better than the guaranteed rate, there will be an excess amount in the policy at the end of the withdrawal period. If they perform poorly and the account value is depleted before the end of the withdrawal period, the investor can still continue to make withdrawals until the full amount of the original investment is recovered.

If the investor decides to terminate the contract before the end of the withdrawal period, they will receive the cash surrender value of the contract. A “step-up feature” or “ratchet” can periodically lock in higher guaranteed withdrawals if investments do well.

Guaranteed Lifetime Withdrawal Benefit (GLWB)
A variation of a GMWB rider that guarantees withdrawals for life. The guaranteed lifetime withdrawal benefit guarantees that a certain percentage (typically 2-8%) of the amount invested can be withdrawn each year for as long as the contract holder lives. This percentage varies depending on the person's age and when withdrawals begin.

Types of Annuities and Specific Features

Fixed Annuities

- Guaranteed rate of return that may change at the issuer's discretion as overall short term yields increase or decline but never lower than the contract's guaranteed minimum rate (rates are similar to CD's)
- Generally have contingent deferred surrender charges (CDSC) of 6%-8% during the first 7 or 8 years
- **Investment risk borne by the issuer**
- Low internal expenses
- Payout may be immediate or deferred
- Many settlement (payout) options are available (Single, Joint, Joint and Survivor, Periods Certain, Life no Refund)

Market Value Adjusted (MVA) Annuities

- A variation of a fixed annuity with a market value adjustment feature
- A **guaranteed fixed rate** is declared for the length of each **guarantee term**
- The guarantee terms range from short to long and typically credit higher interest rates for longer-term commitments
- Generally credit higher rates than traditional fixed annuities
- Investments may be split among several guarantee terms to match various time horizons when funds may need to be accessed (similar to a laddered bond portfolio).
- Withdrawals made before maturity of the guarantee term may be subject to a contingent deferred sales charge (CDSC) and/or a market value adjustment (MVA). If interest rates rise, adjustment is negative – if interest rates fall, adjustment is positive

Variable Annuities

- **Investment risk is borne by the investor**
- Broad array of sub accounts resembling mutual funds often including a fixed or guaranteed account
- CDSC and surrender periods similar to Fixed
- Complex "Living Benefit Riders" are available that may guarantee accumulation values, withdrawals amounts, lifetime income, etc. These riders are restrictive, conditional and sometimes irrevocable and can add 80 – 160 bps of additional cost
- Enhanced Death Benefit Riders are available that generally add 25 – 70 bps of cost
- Many settlement options are available (Same as Fixed)
- "Advisor Series" are available that are fully liquid, lower cost (circa 35-40 bps), less frills intended to be sold within managed portfolios with asset based fees

Indexed Annuities

- An indexed annuity credits returns based on the changes in a securities index during a certain period of time, such as the S&P 500® Composite Stock Price Index.
- All such contracts have "**caps**" which limit the amount of gain that can be credited in a given period, "**participation rates**" such as 80% or 100% which define the percent participation in a given index and a "**point to point measuring period**"
- Regardless of the performance of the index, the contract will never credit less than 0% in a given period
- May also have a "**declared rate**" which is a guaranteed interest rate that can be coupled with an index
- May also have limited living benefit riders similar to Variable Annuities
- Generally have longer surrender periods and higher surrender charges than other types of annuities

Common Fees and Expenses in Annuities

(Expressed in basis points which are hundredths of 1 percent – 100 bps = 1%)

Administration/contract maintenance charge
These charges cover the cost of maintaining the policy, including accounting and record-keeping

Contingent deferred sales charge (CDSC)
The CDSC pays for sales expenses such as commissions, promotions and sales materials. It is deducted from your cash value if you surrender (terminate) your contract before the end of your surrender charge period. Be sure to check the length of your surrender charge period when evaluating a contract to buy, since it can vary

Mortality and expense risk charge (M&E)
These charges compensate the insurance company/issuer for guaranteeing that annuity purchase rates and charges will not change, regardless of mortality rates or actual expenses

Premium tax
This charge reimburses the insurance company/issuer for any premium taxes levied by a state or other government entity

Short-term trading fees
These fees compensate the underlying mutual fund and its contract owners for the negative impact on fund performance that can result from frequent, short-term trading strategies employed by the annuity owner

Underlying mutual fund expenses
These expenses are deducted from underlying mutual fund assets and pay for fund management, distribution (12b-1) fees and other expenses

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Administrative Expenses
Many variable annuity policies have a separate administrative fee to cover the costs of mailings and ongoing service. This fee can range from 10 -30 bps of the policy value per year

Investment Expense Ratio (Management Fees)
Inside a variable annuity, the underlying stock and bond investment choices, called sub-accounts, will have an investment management fee which can range from 25 – 200 bps of the value in that account per year

Additional Cost of Riders
Extra features on your variable annuity policy that provide additional guarantees or death benefits. Depending on the extent of the benefit, each rider can cost 25 – 100 bps of the policy value per year

Surrender Charges
Many annuities pay an upfront commission to the person who sells it. A surrender charge is put on the annuity policy so that if you cancel the policy early, the insurance company can recoup the commission they had to pay out. Most annuities have some free withdrawal provision allowing the owner to withdraw a limited amount per year without penalty – typically around 10%

Why Would Anyone Buy One

Annuities are particularly appropriate when they are used to provide income and manage risk even more so in retirement. **By utilizing the guarantees provided by the riders, they are capable of insuring against three critical risks all investors face in retirement; sequence of returns, longevity and Inflation.**

1) **Sequence of Returns Risk** can be seen as the risk of receiving lower or negative returns early in retirement while withdrawals are being made from the underlying investments. The order or the sequence of investment returns is a primary concern for those individuals who are retired and living off the **income and capital** of their investments.

The two portfolios illustrated below have equal staring values of $1,000,000 and equal average returns of 5% and equal withdrawals of $40,000 per year. As you can see, the fund balance at the end of 20 years in the portfolio with early losses is $1,303,541 less than the one with losses later!

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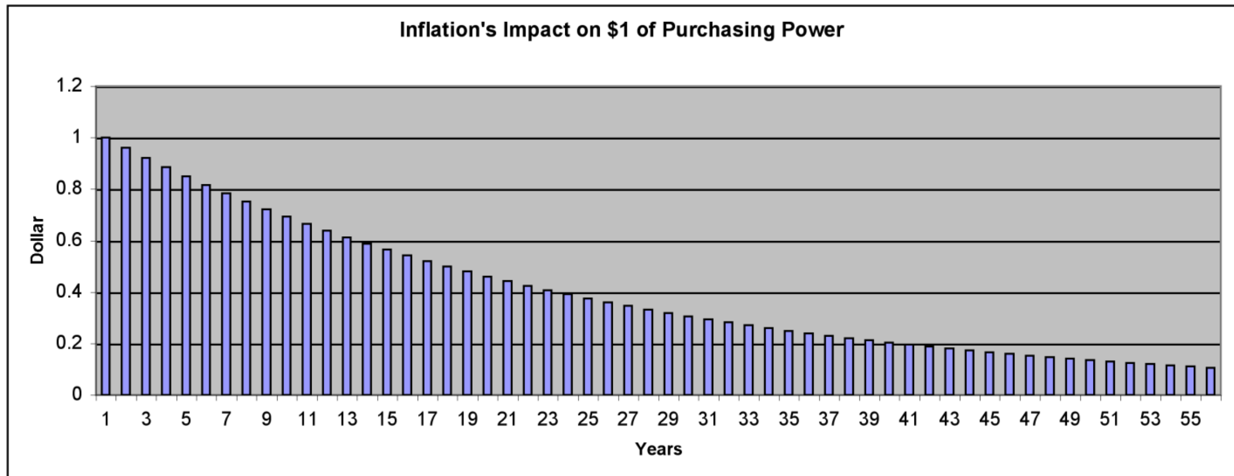
	Down-then-Up Scenario			Up-then-Down Scenario		
Year	Return	Annual Income	Nest Egg Remaining	Return	Annual Income	Nest Egg Remaining
0			1,000,000			1,000,000
1	-5%	40,000	912,000	15%	40,000	1,104,000
2	-5%	40,000	828,400	15%	40,000	1,223,600
3	-5%	40,000	748,980	15%	40,000	1,361,140
4	-5%	40,000	673,531	15%	40,000	1,519,311
5	-5%	40,000	601,854	15%	40,000	1,701,208
6	-5%	40,000	533,762	15%	40,000	1,910,389
7	-5%	40,000	469,074	15%	40,000	2,150,947
8	-5%	40,000	407,620	15%	40,000	2,427,589
9	-5%	40,000	349,239	15%	40,000	2,745,728
10	-5%	40,000	293,777	15%	40,000	3,111,587
11	15%	40,000	291,844	-5%	40,000	2,918,007
12	15%	40,000	289,620	-5%	40,000	2,734,107
13	15%	40,000	287,063	-5%	40,000	2,559,402
14	15%	40,000	284,123	-5%	40,000	2,393,432
15	15%	40,000	280,741	-5%	40,000	2,235,760
16	15%	40,000	276,852	-5%	40,000	2,085,972
17	15%	40,000	272,380	-5%	40,000	1,943,673
18	15%	40,000	267,237	-5%	40,000	1,808,490
19	15%	40,000	261,322	-5%	40,000	1,680,065
20	15%	40,000	254,521	-5%	40,000	1,558,062
Average	5%	40,000		5%	40,000	

2) **Longevity Risk** for individuals is that they have finite savings they are drawing from in retirement. If they live longer than expected they can exhaust their savings. Simply put, if you live too long you can run out of funds.

3) **Inflation Risk** in retirement applies to individuals living off of fixed income streams. The erosion of purchasing power is increased by the inflation rate and time. Assuming even a modest rate of 3% inflation, purchasing power is cut nearly in half in 20 years as illustrated below.



Another way of thinking about inflation risk is that to maintain the same purchasing power you begin retirement with, your annual income needs to increase with inflation. Assuming 3% inflation, you would need $134,392 in your 10th year, $155,797 in your 15th year and $180,611 in your 20th year of retirement to purchase the same goods that $100,000 bought when you began!

A Few Interesting Tax Facts

Section 72 of the Internal Revenue Code allows all annuities to enjoy tax deferred growth during the accumulation phase

Withdrawals during the accumulation phase are taxed Last in First out (LIFO) - growth first principle second

Withdrawals during the payout phase (annuitization) are partially taxable as payments are split between growth and return of principle. The portions are determined by the insurer based upon accumulated growth, assumed ongoing growth and assumed payout period

<u>Any growth or interest that is distributed is taxed as ordinary income</u>

With a few exceptions, withdrawals made before age 59 ½ are subject to a tax penalty of 10%

Unlike other investments, annuities do not get a “stepped up” tax basis when received by a beneficiary. The tax basis remains the same as the decedents and the gain is treated as ordinary income rather than capital gains.

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Disadvantages to Annuities That Can Make Them Unsuitable

Annuities are complex and difficult to understand not only by the consumer but also the advisors that are selling them.

Annuities are expensive compared to other investments and can have total charges exceeding 4% of assets per year.

Annuities pay high commissions ranging from 1% to over 10% in the first year which may provide advisors with incentive to recommend them when better choices are available for their customer.

Many annuities have “dial a commission” features which allow advisors the ability to optimize their compensation as opposed to minimizing the customers cost of ownership.

Certain guarantees and features of annuities can have illusory value making them easy to misrepresent and exaggerate at the point of sale.

“Living Benefits” and other guarantees that are prevalent in annuities are often restrictive and have conditions that can be difficult to live with if the investor’s situation changes.

Annuities convert capital gains to ordinary income causing the investor to pay higher taxes on the investment’s growth.

Annuities Are a Unique Solution

As explained earlier, annuities are the only single investment that can mitigate or eliminate the primary risks present in retirement. Accordingly, they are highly suitable and appropriate when being used to manage those risks.

There is a now a growing body of research that shows guarantees in variable annuities come at bargain prices. Academics, once concerned with price gouging by insurance companies now fear that underpricing of guarantees may jeopardize the financial health of the insurance companies that are creating them.[3]

Even the skeptic will acknowledge that recent advances in life sciences, information technology and the decoding of the human genome increase the probability of life expectancy beyond 100 years in the near future. At the other end of the spectrum, futurists like Ray Kurzweil envision a

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[3] **Financial Valuation of Guaranteed Minimum Withdrawal Benefits** Moshe A. Milevsky Schulich School of Business, York University, Toronto, Ontario, Canada and Thomas S. Salisbury Fields Institute for Research in Mathematical Science and York University Department of Mathematics and Statistics, Toronto, Ontario, Canada Received January 2005; received in revised form June 2005; accepted 30 June 2005*, faculty at York University Toronto*

non-dystopian future where 25 -30 years from now extreme human longevity and even immortality is possible.[4]

Regardless of our personal views, it's becoming difficult to ignore that technological advancement is occurring at an exponential pace. Even if there was a remote possibility that Kurzweil was onto something, we would be remiss in not considering the economic implications of extreme human life extension.

Though troubling, it may be time to question the wisdom of our venerable forefather Benjamin Franklin who left us the ubiquitous quote

"In this world nothing can be said to be certain, except death and taxes"

Conclusion

If annuities can insure against all of the aforementioned risks, is the remaining challenge simply to demonstrate that the insurance adds value beyond its cost?

It should be abundantly clear that annuities are anything but simple and effectively evaluating them requires specific expertise.

Determining whether or not an annuity is a good fit for an investor requires expert knowledge and analysis. A financial advisor, in recommending an annuity or any investment, should have product specific knowledge and demonstrate procedural prudence by performing analysis of a customer's situation and needs, developing a strategy, implementing it and monitoring it.

Acknowledgements and Disclaimer

This paper is intended to be informational and helpful in developing a general understanding of the product. It is not intended to be a recommendation to buy annuities or to avoid them.

The data referenced throughout this paper came from a variety of open sources and my general knowledge and research. Because the features and expenses of annuities are ever changing, the information contained herein cannot be guaranteed though is believed to be accurate. Whenever possible, I have cited the specific author or source of data to the best of my ability. My apologies if any have been overlooked.

[4] ***The Singularity Is Near: When Humans Transcend Biology*** is a 2005 non-fiction book about artificial intelligence and the future of humanity by inventor and futurist Ray Kurzweil.