

# Truths and Myths About Annuities

by Gordon Corwin

Have you heard someone say “There’s just something about Annuities in general that have me in some doubt and I don’t know exactly why”? When the licensed insurance agent responds by asking “Can you tell me exactly what it is that concerns you?” He gets a “No ... maybe it’s just the reputation of an Annuity from some news articles I’ve read.” So, the insurance agent goes on say, “If you can tell me your exact issue here, I’ll tell you as an industry professional whether or not it is valid.” Clients deserve to be fully and accurately informed, thus to become satisfied and comfortable, feeling peace of mind” about their Annuity investments.

## Truth and Myth Come Into Play

You are probably aware of the ‘Main Stream Media’ that reports stories about Annuities. Most times the stories are about variable Annuities or any Annuity that was inappropriately sold. And let’s remember that stories can be written by reporters who are not professionals in the field and sometimes have the story confused, incomplete, or inaccurately convoluted because of the reporter’s limited knowledge of Annuities and the insurance industry itself. So, my dear reader, shall we begin the revelation?

## What is an Annuity?

An Annuity is a long-term financial contract in which an insurance company promises to make a series of payments to a named individual in exchange for a premium or series of premiums. Annuities allow earnings to grow tax-deferred and, therefore, are often used to help provide retirement income. It is the only financial product that offers the opportunity to receive income that cannot be outlived. The insurance industry offers a myriad of products, sometimes combining different types of Annuities into unique hybrid offerings that can amaze even the most imaginative. So here we will be looking mainly at the basics.

It is valuable to mention at the outset the meaning of tax deferral. According to a prominent leading insurance company giant, “Income taxes are deferred on earnings until you receive them, so your money may grow faster than a taxable investment (unlike today’s CD). You should carefully consider other tax benefits and costs before purchasing. Readers are advised and cautioned to consult their own qualified tax advisor regarding such decisions.

## Immediate or Deferred

Annuities are also categorized functionally as immediate or deferred. An immediate Annuity is an income vehicle designed to provide payments within a year (or less) of paying premiums. A deferred Annuity, however, has two phases. During the accumulation phase, the money you put into the Annuity earns interest. Any earnings grow tax-deferred as long as you leave them in the Annuity during the second phase, called the payout period, when the company pays income to you or to person (s) you choose called beneficiary (s).

## Types of Annuities

We must be clear that there are two (2) general types of Annuities: Fixed Annuities and Variable Annuities.

With **fixed Annuities** the investor is paid in principal (premium) and is guaranteed and protected by the general assets of the issuing Insurance Company. Fixed Annuities are NOT stock market products, *thereby eliminating RISK of losing principal due to stock market fluctuations, a risk that you face with variable Annuities.* Note, however, the investor must also follow the conditions of the Annuity contract, such as surrender periods, to maximize the benefits and hold onto the principal minus any withdrawals.

Interest rate returns will vary depending upon the product purchased, currently in the 4 % to 5.5 % range tax-deferred, and may be adjusted annually by the issuing company to reflect current economic conditions. Important note: *Some leading insurance companies offer fixed Annuities free of any fees whatsoever.*

These rates of return are commensurate with the decreased risk, and yet are still competitive with insured accounts such as CDs, in fact superior when you consider large benefits of triple compound interest and tax deferral which can easily jump these effective Annuity yields up by 30% or more leaving CDs less attractive in many respects.

### **Fixed Annuities include Fixed-Indexed Annuities**

Here the investor's interest return on funds allocated to this account is *linked to the performance of a certain market index of the investor's choice*. An index could be the S&P 500, Dow, Euro STOXX50, Russell 2000 index, etc. Each such Annuity product has its own index parameters which are used to calculate the annual interest return on each contract anniversary. A cap rate product, for example, will credit an investor with interest equal to the gain of the chosen index during the year, capped at the annual index cap rate. This is when the index goes up. The best part is that even if index performance is negative for the year, your accumulation value (principal) will not decrease due to the negative index performance. Although there is no interest credited, the investor's principal remains locked in and untouched.

You might say there is a floor set beneath the accumulation value. *This value can go up but can not go down with respect to index crediting*. Better yet, the principal itself is never invested in the stock market whatsoever. (It should be noted that the accumulation value can be decreased by withdrawals and early surrender charges).

The benefits of these fixed and indexed Annuities can include future income, guaranteed income for life, tax deferred growth, liquidity, and more. Penalty-free withdrawals of 10% per year are often offered for liquidity after the first contract year.

A fixed Annuity can be the perfect place for your IRA.

### **Variable Annuities**

These are clearly stock market products. They lure investors who hunger for the very highest returns that they can get on the planet, some believing the myth that there is no risk here, even though risk is squarely facing them every day as the stock market closes. With variable Annuities, the investor's principal allocated to the stock market is placed in a separate account and invested, usually mutual funds. Rate of return and risk are tied to performance of the underlying market-based portfolios. Principal value, income payments, and investment returns of a variable Annuity will fluctuate and you may have a gain or loss when money is received. It's that simple.

So how well do you want to sleep at night? The unfortunate myth here is that variable Annuities are sometimes marketed and purchased under the belief that principal is protected, without adequate explanation or understanding!

Please beware of the distinctions made in this article and heed your own due diligence research.

Aware folks who do purchase variable Annuities feel wealthy enough to stand the high risk of losing principal with the prospect of realizing a considerably higher return.

But, there is more. Some Variable Annuities are offered by stock broker dealers with 'guaranteed growth rates' of 6 to 7 %. By now, we all know there is no free lunch in the market. So the catch is that you are sold a "rider" and pay additional money going in for these 'guarantees'. Your rider dollars pay dearly for the guarantee you are getting! Do examine these offers with great scrutiny. The actuarial mathematicians who invent these products are paid to see that the house wins.

The expenses do not stop there. In contrast to the Fixed Annuity offerings with NO FEES as mentioned earlier, Variable Annuities can have significant mutual fund fees and 'loads' are charged to you on top of commissions when mutual funds are purchased with your money. Some of these costs

to you are visible and some are nearly invisible, buried beyond recognition of the average investor. So what this means to you is that your principal is eroded. If you are fortunate, the gains will outstrip these high costs. If not, a mainstream news reporter can have a discontented person to write about; a person who was not aware enough to be fully informed to realize these costs and the workings of their investment. And in fairness, the industry has been known to not fully explain the workings of a Variable Annuity, also part of the problem.

Now along comes the 'main stream news story' and out pops the would-be investor who now has this vague and indescribable "icky and queasy feeling" about Annuities because of what he or she has read in a news story. Cause and effect would you say?

### **What is the Solution?**

It is my firm belief that an investor need be fully informed via all means about what is being purchased BEFORE making the investment. It is a dual responsibility of client and agent alike!

This has been the missing link. Let's call this Annuity Awareness. These items include key questions such as:

1. Is my principal ever at risk?
2. What is the rating of the insurance company backing my Annuity? (A+, AA, BB, etc.)
3. Is the proposed Annuity appropriate for me under my circumstances?
4. What are the income options for me?
5. Can I maximize the amount of money given to children, church or charity?  
(Long Term Care (LTC) Insurance can be a huge factor here).
6. Would it be wise to roll over my IRA or retirement account into a fixed Annuity to avoid stock market risks, maximize my return, and more?

Liquidity, safety and control are foremost in almost everyone's mind now. Some insurance agents will help clients with only Fixed Annuities. It's a matter of conscience. The Fixed Annuity is a safe, long-term investment approach often for retirement funds where the principal is protected and guaranteed and many options are open for choice. Clients then have safety and control, along with significant benefits of tax deferral, competitive yields, bonuses available at purchase and end of term. Income distribution, if desired, can be monthly, semi-annual, or annual. These freedoms of choice also allow more money to be added or taken out, depending on the product.

***Readers are cautioned to consult a qualified advisor of their own selection with respect to any particular situation and anything contained herein. The author is not a CPA or attorney. This material is informational in nature and should not be interpreted as tax advice by the reader.***

*Gordon Corwin is a Certified Estate Advisor and an active California Insurance Agent with Corwin Asset Management, Inc. as well as a real estate broker in San Diego County. He brings over 25 years of business and investment experience, specializing in helping investors with fixed and indexed Annuities, along with long term care insurance (LTC). For more information, phone 760-941-5478.*