THE MONEY MARATHON - THE BASICS OF ANNUITIES

By Ed Douglas – December 2010

Annuities can be mysterious and complicated products. Here are some basics about annuities that may help make them more understandable.

WHAT IS AN ANNUITY?

Annuities are investments products offered by the insurance industry sold through insurance companies or brokerage firms.

WHAT ARE THE BASIC TYPES OF ANNUITIES?

The two basic types of annuities are fixed and variable.

Fixed Annuities:

A fixed annuity pays a guaranteed rate and principal is also guaranteed by the insurance company based on the insurance company's own assets. There is less risk to a fixed annuity but also there is a limited chance for rapid growth of the investment.

Variable Annuities:

A variable annuity produces investment returns based on the returns on the investment made through the annuity. A variable annuity is a separate account not guaranteed by the insurance company which can be invested in investments like stocks which can allow the potential return to be larger, but with more risk. Fixed and variable annuities can also be either immediate or deferred.

Immediate Annuities:

Annuities that begin payments shortly after purchase are called immediate annuities. The dictionary defines this process of annuitization as follows:
Annuitization means that a person converts part or all of the money in a qualified plan or a nonqualified annuity contract into a stream of regular income. The owner has the option to take a stream of payments over any time frame he desires.

These products are usually used by an investor to generate retirement income for life. Insurance companies will pay income and principal out for life to the owner based on the life expectancy of the annuitant. (The annuitant is the person whose age is used to determine the payment, normally the investor.) The payout to the investor is also based on the investment return the insurance company can guaranty over the life of the investment, which can depend in part on current market conditions. The significant benefit to this product is that since insurance companies use the law of large numbers to spread risk, the company can predict the life expectancy of the average person based on a person's age and gender. If the investor beats the average and lives to be 110, the insurance company can afford to pay out this benefit because others will die sooner than average, which equalizes the company's risk. The investor usually gets a higher payment than he could get from the income alone from a comparable fixed income investment. The reason the return is higher is that, in practice, the investor in an immediate annuity is receiving part of his principal back too, which increases the payout. There are downsides to this type of annuity. The first downside is the inability to spend the principal. Principal in an annuity is normally not available to tap for expenses, with some exceptions. Furthermore, annuities typically do not increase the payout from the original payout so the investor can lose his purchasing power over time from inflation. Finally, when the annuitant dies, the principal is typically not available to the annuitant's heirs. (Many annuities continue to pay payouts to the spouse for life and many pay for a period certain, but normally when the period certain payout is over and both spouses die, there is no principal left to pay to heirs. It is important to pick the payout option that works best for the owner.) Remember that is how the insurance company can pay out a higher figure by returning interest and principal for the life of the annuitant.

Deferred annuities:
A deferred annuity means there is no payout of income until a later date. Both fixed and variable annuities can be deferred. A deferred annuity can become an immediate annuity at a larger date, at the owner's choice, but this is not a requirement. The income on deferred annuities grows tax deferred which means the investment can compound faster than an equivalent taxable investment. Withdrawals from annuities before age 59 ½ have tax penalties, similar to IRAs, so most investment in deferred annuities is done close to the age of 50 and over which is reasonably close to age 59 ½. Deferred annuities can help supplement retirement plans with additional deferred income growth.

Annuity Variations:
There are many different annuity products on the market. Annuities can pay out for the life of a single individual, (highest payout) or the joint life of a couple (lower payout) and or can have a guaranteed term of payout regardless of death (example a minimum 10 year certain payout regardless of death).

Most annuities will provide limited access to the principal, and some increase the annual payout and some variable annuities will offer a guaranteed lifetime withdrawal benefit. The payout for an annuity is less with added benefits because there is a cost to offering these added provisions.

OTHER CONSIDERATIONS:
Variable annuities can come with some relatively high fees of up to 3% which can lower the growth potential. Be sure to understand the cost structure.

An annuity is a guaranty from the issuing insurance company so it is very important to be sure that the insurance company selling the product is a strong company. Standard & Poors and A.M. Best rate insurance companies. Higher ratings mean more financial strength. A++ is the highest rating by A.M. Best. Additionally, each state has a fund that is paid into by all the insurance companies that guarantees annuity payout to annuitants if an individual company fails. The limit on the guaranty in the State of Missouri is $100,000 per company, per owner.

SELECTED USES FOR ANNUITIES:
Let's say that a 65 year old man wants to maximize his retirement income but wants to do it safely or with very little volatility or risk. A ten-year government bond might currently pay 2.90% which on $100,000 would be approximately $2900 per year. Alternately, an immediate annuity might pay 6% for life which would provide $6,000 on that $100,000 investment. The trade off for the higher return is that the payout stops when the annuitant dies and the other provisions of the contract are fulfilled. For many people an annuity can be a method to increase the amount of money that is available for them to spend annually. Normally, because of the limited access to these funds and the fact that principal can be gone when the owner or joint owners die and the period certain payout is met, investors usually do not put more than 25% to 50% of their investments into this type of product. Another way to say this is that immediate annuities can eliminate market and longevity risk, but introduce the risk that income is based on the life of the insured.

One investment strategy involving annuities used by some financial planners allows an investor to spend over the normally excepted safe withdrawal rate on investments, which is normally considered 4%. The fall-back provision is that if investment returns are lower than expected and the principal of the investments decline more than anticipated, then an annuity can be purchased later in life to replace the required income without running out of money. As an example, let's say a retiree had $500,000 in a retirement fund at age 65 and choose to withdraw 6% or $30,000 instead of the standard, more conservative of 4% or $20,000. If this higher withdrawal rate lowered the funds down to $300,000 by age 80 or 85, (different companies have different age restrictions) the investor could purchase an annuity at that time that could possibly pay 10% based on his shorter life expectancy at this time. Although the principal may be gone at death if all the contract provisions are met, the 10% payout on $300,000 would generate the same $30,000 of funds to spend. Alternately, if the original principal of $500,000 had not declined, an annuity purchase would not be necessary. The owner could continue to draw the 6%, still expect not to run out of money and be able to leave the principal to his heirs.

CONCLUSION:
Annuities can be complicated and complex products but that can have important uses dependent on the individual's particular financial situation. Be sure and talk to a professional about the details of specific products in conjunction with analysis of an investor's individual needs and circumstances.

Remember - every investor's situation is unique and it is important to review your specific situation with a financial professional.

Ed Douglas is a Certified Financial Planner/Consultant, Chairman Emeritus of Citizens Bancshares and author of three books, "Making a Million With Only $2000-Every Young Person Can Do It" , "The Money Marathon: 7 Simple Steps to Financial Freedom" and his new book " 25 Truths: Winning Wisdom for a Better Life", available at www.eddouglas.com. Ed may be contacted at ed@eddouglas.com or 660-646-2066 or at his office at 601 Locust, Chillicothe, Missouri.