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Guaranteed Returns, Income, and Withdrawals -- Oh, My!

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If you've read about annuities in the financial press, you probably think the brokers who sell these products are the financial-services equivalents of snake oil salesmen. That's quite an indictment, given the history of snake oil. Consider the case of Clark Stanley, the self-proclaimed "Rattlesnake King" who became famous at the 1893 Chicago World's Fair for performances that involved killing rattlesnakes and supposedly turning their innards into a pain-killing ointment. An analysis of his product in 1917 found that the oil probably came from beef. Not only did his snake oil lack pain-relieving benefits, it also lacked snakes. He was fined $20.

Just like that slither-free salve, annuities are often accused of not being as good as billed. You've heard that "annuities are sold, not bought"? In other words, investors don't go looking for an annuity; an annuity-pushing salesperson looks for investors. It is telling that, within the industry, annuity salesmen are referred to as "producers" — because they're selling a product, not providing advice. And they're doing a pretty good job of it: According to industry trade organization LIMRA, sales of annuities from 2004 to 2013 topped $2.3 *trillion*.

You might be thinking, "There must be *something* good about annuities. People aren't so gullible as to spend that much money for snake oil in beef's clothing." Which is why you're so smart, Fool, because annuities do indeed have many benefits.

So let's dive into the murky waters of the annuity world and try to separate the pearls from the eels. Here, we'll introduce the major types of annuities along with their pros and cons. In a later article, we'll provide specific examples of actual products, how to choose a good one, and what to do if you already have a bad one.

What's an Annuity?

Annuities are insurance products that, depending on the type and the features chosen by the owner, provide one or more of the following:

- Guaranteed income for life
- A guaranteed rate of return
- Tax-deferred investment growth
- A guaranteed death benefit for heirs
- Potential bankruptcy and creditor protection

Doesn't that sound great? It should — and much of it is even true. Unfortunately, these benefits need to be compared with these drawbacks:

1. Annuities are complicated and confusing.

The characteristics of annuities can vary greatly from one company to another — and then from one client to another, depending on the features. Prospectuses and contracts can range from about 50 pages to several hundred, and much of the terminology hasn't been standardized across the industry.

2. Brokers and agents are incentivized to push annuities.

Agents and brokers who sell annuities can receive up-front commissions on them of as much as 10%. Compare that with the highest typical up-front commission on a mutual fund of 5.75%. There may also be "trailing commissions" that pay the broker or agent for years or even for the life of the contract. Annuities are one of the biggest conflicts of interest in the financial-services industry.

3. They're daaaang expensive.

The average variable annuity has an annual expense of 2.5%. This includes the cost of the investments and the insurance (commonly referred to "mortality and expense charges," or M&E). However, that figure does not include the costs of optional riders that are common because they're often the main selling points.

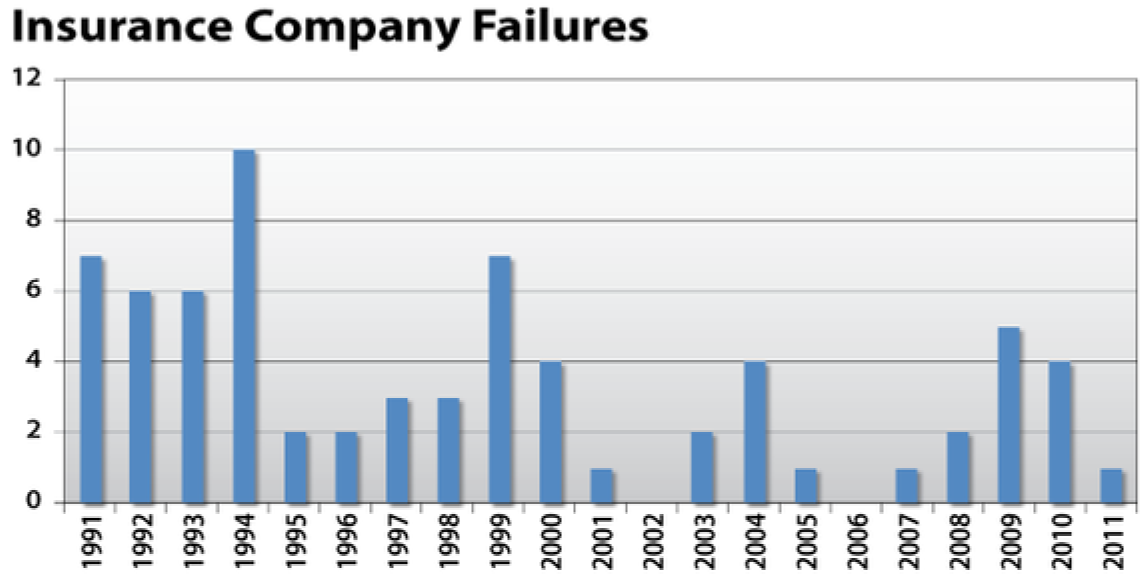
4. Potentially higher taxes, penalties, and other costs.

Withdrawals may be taxed as ordinary income (rather than as long-term capital gains) and penalized if investor is not 59 ½. Also, some annuities assess "surrender" charges on withdrawals made within a certain number of years.

Nothing in Life Is Guaranteed

While the word "guaranteed" is used when describing annuities, the guarantee is only as good as long as the insurance company is in business. However, a few factors mitigate this risk:

1. States have guaranty funds that cover \$100,000 to \$500,000 of losses, depending on the state and type of annuity.
2. From 1991 to 2012, there were only 70 insurance company failures for which state guaranty funds were required to backstop losses.



Source: "How Safe Are Annuities" by Joe Tomlinson, AdvisorPerspectives.com

Types of Annuities

The characteristics and optional features of annuities are legion, and the labels aren't consistent. For example, the definition of a "fixed annuity" varies. Below are basic descriptions of the three major types.

1. Income or Immediate Annuity

The investor pays a lump sum or a series of payments to the insurance company, which then sends the investor a monthly or annual check for as long as the investor lives. Upon death, payments cease and heirs do not receive anything. However, there are variations that will provide for a return of principal or payments to continue to a spouse or other heirs either for the rest of their lives or a certain number of years, but at the cost of lower regular payments.

Pros

- You can't outlive the payments.
- Payments are immune from market risk.
- Income is protected from any poor decisions you might make because of cognitive decline. (According to Harvard's David Laibson, half of investors in their 80s experience some sort of mental decline that impairs financial judgment.)
- There's peace of mind in knowing you have a reliable source of income in retirement.
- They provide potential bankruptcy and creditor protection.

Cons

- They're not liquid — once the insurance company has the money, you can't get it back beyond the regular payments (though some variants allow more flexibility).
- Payments are generally fixed for life and don't keep up with inflation.
- Interest rates play a significant role in determining payments, and historically low rates mean payments from current annuities are low.

Real-Life Example No. 1

Here's an estimate of how much annual income a 65-year-old man would receive after buying a $100,000 immediate annuity.

Type	Annual Income	Explanation
Single Life Only	$6,552	The company pays that fixed amount until the owner dies
Single Life With 5 Years Certain	$6,492	The company pays that amount for five years or until the owner dies, whichever comes later
Single Life With 10 Years Certain	$6,360	The company pays that amount for 10 years or until the owner dies, whichever comes later

Source: ImmediateAnnuities.com

Real-Life Example No. 2

You can buy an annuity that pays income now (an "immediate annuity") or in the future (a "deferred annuity," sometimes called "longevity insurance"). Here's how Vanguard estimates the cost of an annuity that pays out $1,000 a month, starting at different periods. Note that the start date is as of a year ago, so current numbers will be slightly different.

Deferral Period in Years	Date Payments Begin	Age	Amount Needed to Purchase
0	2/1/2014	65	$167,105
5	2/1/2019	70	$119,540
10	2/1/2024	75	$77,569
15	2/1/2029	80	$47,976
20	2/1/2034	85	$26,894

Source: Vanguard.com

2. Fixed Annuity

The misleadingly named "fixed" annuity pays a guaranteed rate of return, at least for a certain period. A traditional fixed annuity pays a specific rate for a certain number of years and then usually adjusts. An increasingly popular version is the indexed annuity, which pays a guaranteed return with potential upside based on the return of a specific index, such as the S&P 500.

Pros

- Interest rates are generally higher than what are paid on cash or CDs.
- Growth is tax-deferred.
- The interest rate could increase.
- The accumulated amount can be "annuitized" — that is, turned into an income annuity.
- They provide potential bankruptcy and creditor protection.

Cons

- They're illiquid; withdrawals before a certain number of years (the "surrender period") may be subject to charges.
- The rate often isn't fixed and could decrease.
- For indexed annuities, the way an index's performance affects the interest rate is complicated — and often not as good as promoted because of caps, expenses, and the exclusion of dividends from the formula. We'll illustrate this in more detail in a later article.

Real-Life Examples

The following fixed annuities are available through the Fidelity Insurance Network. The "guarantee" is how long the interest rate is fixed. The "surrender period" is how long you must hold the annuity without paying charges. The "base rate" is what's paid on the minimum investment amount. The "jumbo rate" is paid on bigger investments, the amount of which varies by company but is generally about $100,000.

Issuer/Product	Guarantee/Surrender Period	Base Rate	Jumbo Rate
New York Life Secure Term MVA Fixed II	3/3 years	1.25%	1.40%
MassMutual Stable VoyageSM	5/5 years	1.50%	1.75%
New York Life Secure Term MVA Fixed II	5/5 years	1.75%	1.90%
Principal Select Series	5/5 years	1.45%	1.65%
Guardian Fixed Target AnnuitySM	6/6 years	1.40%	1.60%
MetLife Target Maturity	6/6 years	1.75%	—
New York Life Secure Term MVA Fixed II	6/6 years	1.85%	2.00%

Issuer/Product	Guarantee/Surrender Period	Base Rate	Jumbo Rate
MassMutual Stable VoyageSM	7/7 years	1.55%	1.80%
MetLife Target Maturity	7/7 years	1.90%	—
Principal Select Series	7/7 years	1.80%	2.05%
MassMutual Stable VoyageSM	9/9 years	1.60%	1.85%
Principal Select Series	9/9 years	1.85%	2.05%
MetLife Target Maturity	10/7 years	2.40%	—

Source: Fidelity.com

3. Variable Annuity

With income and fixed annuities, you don't have any say over how the money you give the insurance company is invested. Variable annuities are different. They allow you to choose from among a selection of "sub-accounts" — essentially, mutual funds with higher expenses. The choices are similar to what you'd see in a 401(k) — you know, stock funds, bond funds, target retirement funds, etc. The value of the annuity goes up and down according to investments you choose — that's what the "variable" part is all about.

So if the value of the annuity will be determined by the market, what are you getting for the insurance fees you're paying? Chances are, not much. The bare-bones "guarantee" you're getting is that your heirs will inherit the value of the account. Yep, that's right — if your annuity is worth $100,000 when you die, your heirs will get ... $100,000. Not much of a guarantee, is it?

Another "death benefit" is a guarantee that your heirs will get the value of the annuity or the amount you paid in premiums (minus withdrawals), whichever is higher. That provides some peace of mind if you're concerned about a market crash causing your heirs to get a smaller inheritance. For some annuities, this is the built-in "guaranteed minimum death benefit." For others, it costs 0.10% to 0.30% more a year. Still other types of death benefits allow you to lock in investment growth for your heirs (known as a stepped-up death benefit) but at an even higher annual expense.

Variable annuities can also contain optional "living benefits" that offer a range of promises, including a guaranteed future accumulated amount, a guaranteed withdrawal rate, or a guaranteed amount of income in retirement without annuitizing. These can be complicated but also have become increasingly popular, so we'll delve more deeply into specific offerings in a future article.

Pros

- Growth is tax-deferred.
- Returns are potentially higher than with fixed annuities.
- Optional riders can guarantee certain benefits that provide peace of mind.
- They provide potential bankruptcy and creditor protection.

Cons

- The layers of fees (investment, insurance, administrative, and riders) make variable annuities a much more expensive way to invest than buying and holding stocks, low-cost funds, or index funds and ETFs.
- The funds themselves have higher expenses than equivalent funds outside the annuity. For example, the expense ratio of the **Vanguard 500** (VFINX) mutual fund is 0.17%. However, the equivalent option within Vanguard's own annuity is 0.46%.
- Despite insurance costs (M&E) being part of any variable annuity, the "guarantees" are often negligible.
- Additional guarantees add more fees. For example, guaranteed minimum life benefits (such as guaranteed withdrawals or income) can add 1% to 2% to annual costs.
- Withdrawals may be subject to surrender charges if taken within a certain number of years.

Real-Life Examples

Variable Annuities Offered by Lower-Cost Providers

	Annual Insurance and Administrative Fees	**Investment Options**	**Annual Investment Fees**	**Price of Guaranteed Minimum Death Benefit**	**Other Available Riders**	**Surrender Period**	**Policy Issuer, Ratings**
Fidelity Personal Retirement Annuity	0.25% (0.10% if account > $1 million)	> 55 funds, mostly Fidelity	0.10% to 1.71%	Not available	None	None	Fidelity Life Insurance, A+ (A.M. Best), A+ (S&P)
TIAA-CREF Intelligent Variable Annuity	0.25% to 0.50% (depending on amount of assets)	55 funds, mostly TIAA-CREF	0.10% to 1.39%	0.10% (guarantees that heirs inherit value of premiums paid)	None	None	TIAA-CREF Life Insurance, A++ (A.M. Best), AA+ (S&P)
Vanguard Variable Annuity	0.30%	17 Vanguard funds	0.46% to 0.77%	0.20% (guarantees that heirs inherit value of	Guaranteed lifetime withdrawal benefit (1.20%)	None	Transamerica Premier Life, A+ (A.M. Best), AA-

Annual Insurance and Administrative Fees	Investment Options	Annual Investment Fees	Price of Guaranteed Minimum Death Benefit	Other Available Riders	Surrender Period	Policy Issuer, Ratings
			premiums paid)			(S&P)

Robert Brokamp owns shares of the Vanguard 500.