Is Your Annuity Good or Bad?

...protecting your money & your retirement

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About the Author…

Dr. Shelby Smith has over three decades of hands-on experience working in financial and retirement services helping average Americans manage their financial risk, selecting suitable investments and preparing retirement plans that work. Smith earned a Ph.D. in Economics from Iowa State University of Science and Technology in 1973 following Bachelors' and Masters' degrees in Economics from the University of Wyoming.

During his professional career, Smith has been a college professor of finance, insurance and real estate; Chief Economist for a Federal Home Loan Bank; Chief Financial Officer of a large financial institution; Chairman & CEO of a large mortgage banking company; founder of a financial services company that specialized in serving banks; consultant to insurance and brokerage firms.

He is currently the President of BHC Marketing which is involved in retirement planning nationwide, Internet Commerce and the training of financial advisors/planners. This long and varied career has exposed Dr. Smith to a wide variety of financial-investment-retirement situations where he has witnessed countless thousands of successes and mistakes made by those preparing for and living in retirement.

Smith has written extensively in financial industry publications and frequently speaks and lectures to industry groups. He has held several securities and insurance licenses and routinely advises and coaches financial planners. He is a regular contributor of articles and seminar videos to consumer web sites and an active blogger for the retirement-minded.

Dr. Smith advocates a common sense approach to financial planning and encourages the retirement-minded to stay within their risk tolerances by learning as much as they can independently before working with a financial advisor. Smith resides in Houston, Texas.

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Introduction

Annuities are probably the most maligned and misunderstood of all safe investment alternatives. They are often championed as the best thing since paper money by those who sell them and smeared by stockbrokers, business reporters and virtually everyone selling securities (Personally, I've never understood why investments that have risk are called "securities"). In fact, no financial product is universally good or bad for all people: annuities are no exception. But, annuities *do* fill a void for conservative Americans looking for a safe place to save money. If you're looking for excitement, wild price swings and something to talk about during happy hour, forget annuities and go for investments that rise and fall like a kite in a high wind. Just be sure you can handle the risks.

Possibly, you already own an annuity or are thinking about placing your hard earned money into one. After all, on average about $200 billion annually is put into annuities. If you're considering an annuity, you should plan to keep your annuity for the longer term—five years or more. If your investment horizon is less than five years, think bank! Like many other alternatives, annuities typically need at least five years to deliver the most attractive results. The longer the growing season for your financial garden, the larger the harvest is likely to be.

Nonetheless, annuities are not for everyone, nor are all annuities created equal: some carry no market risks (fixed and index-linked annuities) whereas others are subject to the market's ups and downs (variable annuities). Just because you are willing and able to make longer term investments doesn't make annuities the right choice for you. My purpose in telling you about annuities is to help you understand them better and to pick those that are appropriate for you or to get rid of the ones you shouldn't have bought in the first place. You'll learn which ones to keep and which ones to throw back.

Sadly, the press isn't much help in learning about annuities either because journalists haven't taken the time to learn about them, or worse, he or she may have an agenda other than full disclosure. In fact, some financial columnists make their living selling securities. To some extent, newspapers depend on advertising purchased by brokerage firms and banks, and use the information supplied by them. They need these advertisers and don't want to alienate them. Bear in mind that brokerage firms and banks suffer wallet share loss every time one of their clients buys an annuity. In other words, it is not in their best interest to say complementary things about annuities. Why would a banker that sells FDIC insured CDs or a stockbroker that sells stocks and bonds have anything good to say about annuities? Would brokerage firms advertise in a newspaper, or treat a reporter to a power lunch, if they tend to praise annuities? Would you get objective information about the need to preserve the wolf population from sheep ranchers whose animals are being eaten by wolves? In both cases, I think not.

In that context, it's obvious why bankers and brokers are so anti-annuities. Don't hold your breath waiting for them to admit their biases. Frankly, their prejudices are so ingrained they actually buy their own stories. I'd like to set the record straight by giving you the real story about annuities. (Just for the record, I'm neither a banker nor stockbroker but I do have some of my retirement money in annuities.)

My objective is to empower you with sufficient information to determine if the annuity you own, or are considering, is right for you. I will show you how to weigh your annuity on the "Good-Bad Annuity Scale" and draw your own conclusions. If you understand what an annuity can and cannot do, it will be hard to fool you into buying something you don't need or not buy something you really do need. It is just as bad to miss the bus as it is to take the wrong bus, because either way you won't get to your destination. I want you on the right bus to a happy retirement where you'll earn the most from the money you've saved for your golden years.

By the way, Americans purchase more than $200 billion in annuities each year and *trillions* of dollars are currently invested in annuities. That's a lot of money sheltered from current income taxes, out of the reach of most creditors, that can be used to buy a guaranteed lifetime income you can't outlive, and that will bypass probate when the final trumpet sounds. The majority of these annuities were not sold by banks and stockbrokers (they were busy selling CDs and securities), and they're understandably unhappy about their lost profits and commissions. I can see their point… but it's your money. I want to make sure it stays your money, so read on!

Overview

As a class, annuities are older than dirt. They've been around for centuries and have passed the test of time: they serve a useful purpose for the right set of circumstances. They have cycled in and out of popularity with individuals in response to changing tax laws, interest rate gyrations and economic conditions. Attorneys use annuities in the settlement of personal injury cases that pay lifetime benefits to the injured party. States use them to pay lottery winners who choose the installment payment option. Employers and governments use them to pay pension benefits to retired workers. You've got to admit, that's a pretty impressive line-up of users. So, the next time you hear or read that annuities are universally bad for everyone, remember who uses them in addition to average retirement-minded citizens.

Annuities are available in virtually every country around the world, and no doubt will continue to be an important savings and investment option. Of course, like all savings and investment options, annuities are not right for everyone. But, neither are mutual funds, bank CDs, stocks, real estate or any other investment. If you are satisfied with a market rate of return, want to avoid the risk of principal loss, would like to lock up a guaranteed lifetime income you can't outlive and can benefit from deferring income taxes, annuities could have a place in your retirement portfolio. On the other hand, if you're trying to double your money quickly, enjoy the risk and excitement of economic cycles, and don't mind paying income taxes on earnings you're not currently using, then annuities are probably not for you. You're in the best position to decide if you can benefit from what annuities can do. All you need is a bit more knowledge which I'm going to provide.

Annuities come in several different types and are issued by insurance companies. They are the same insurance companies that insure your house, car, health, life, business and every other possession you value; so you can stop worrying about them not paying off. The three primary annuity types are variable, fixed and income. Predictably, some enterprising insurance companies have combined the features of all three types into a new hybrid annuity design. We'll dissect each of these.

Many years ago, insurance companies in America were successful in convincing Congress to pass laws that gave annuities special tax treatment. This may be the only “pork barrel” program that actually benefits the American public at large! The special treatment is that earnings are free of income taxes until actually withdrawn from the annuity—a huge benefit for the average working person trying to save for retirement or the average retiree who is trying to minimize his or her tax bite.

If tax deferral of an annuity sounds a lot like your IRA and 401(k) account, that’s because the earnings on annuities are treated exactly the same for income tax purposes. And, like a pension account, the IRS will generally tax you extra for withdrawing your money from an annuity (except an income annuity) if you are younger than age 59½. If you don’t withdraw early, you won’t receive a 1099 and no income taxes will be due on your annuity earnings. Before you start jumping up and down with excitement, be aware that the IRS fully intends to take their pound of flesh when you withdraw the earnings from an annuity. But unlike a pension account, the IRS has *not* set an age when you must withdraw your earnings from an annuity. Hopefully you’ll withdraw from your annuity once in retirement when your income tax bracket is likely to be lower, so you’ll pay fewer taxes on the annuity earnings.

This little loophole means you can postpone indefinitely paying income taxes on earnings from your annuity. Said another way, *you* decide when to pay income taxes on earnings rather than the other way around. This alone is a great reason to own an annuity. The deferral of taxes on annuity earnings means the money generally paid to the IRS as income taxes will stay in your account to earn additional interest. This beats a bank CD if you don’t plan to use the money soon (remember, you should plan to keep your money in annuities for five years or longer).

Interest earned on bank CDs and savings accounts are taxable even if not withdrawn. Bankers didn’t get tax deferral on their products from Congress: they got FDIC insurance instead. Personally, I think they both are a good deal which enables you to save your way to a long and happy retirement. However, unlike a bank CD, you won’t get a 1099 for earnings from an annuity until you actually take the money out. This tax deferral is why annuities are generally used by retirement-minded folks. Why pay taxes on earnings you don’t plan to use until many years down the road—or ever?

In fact, tax deferral gives you triple compounding (quadruple compounding if a bonus is also paid when you select your annuity): interest on the principal amount, interest on the interest you've earned, and interest on money that otherwise would have been paid to the tax man. It shouldn't come as a surprise that triple compounding makes your money grow faster than just plain compound interest. Albert Einstein once said that "compound interest was the most powerful force in the universe." That's because not knowing about annuities, Einstein had never heard of triple compounding. Had he known about annuities, imagine what he would have said about triple compound interest!

Triple compounding may be good, but what about safety? Tell the truth now: do you worry about your insurance company not paying if your home burns to the ground or you wreck your car? You worry about the deductible, the loss of sentimental items and things that can't be replaced. But unless you were a hurricane Katrina victim without flood insurance, the insurance company refusing to pay never enters your mind. These same insurance companies are the ones that underwrite annuities, so you can count on them paying when the time comes. Of course, it is always better to deal with insurance companies that are financially strong and have a long, stable operational history. There is no need to worry when dealing with household names that have been around for over a century and operate worldwide.

There have been insurance company failures, just as there have been bank failures, but no one has ever lost a penny in an annuity caused by these business meltdowns. There are two reasons for this:

> First, insurance companies are regulated by their home-state government. If an insurance company fails (and far more banks fail than insurance companies), they are generally merged with government assistance.
>
> Second, each state requires all insurance companies operating in their state to contribute money to a fund that is used strictly to rehabilitate insurance companies and pay policyholders when failed insurance companies can't be merged or sold.

Think about the power of this mutual arrangement among the brotherhood of insurance companies! It means if one company gets out of line, the others have a financial interest in making sure the situation doesn't get out of hand. Also, it sure comes in handy that the

Insurance Commissioner in most states is an elected official. If his or her Honor, the Insurance Commissioner, doesn't take action against failing members of the brotherhood, the other companies might have to pay more into the fund and next election their money would support a reformer. So while annuities are not guaranteed like government bonds and bank CDs, they are rock solid safe and you have nothing to fear. State regulators have done a pretty good job of protecting your interest when it comes to their oversight of insurance companies.

Who Should Buy an Annuity?

Annuity buyers are conservative savers who will not need the money for at least five years. Of course, as I said earlier, this is true for almost any investment because it generally takes that long to get acceptable results. Any money you'll need for the next five years should be locked up in a safe place where you can get it on short notice without paying a penalty or worrying about incurring a loss. In other words, keep it in a money market, savings, or checking account at a bank, credit union, thrift association or purchase an immediate annuity that will pay you an income for a specified period of time.

Also, annuities are perfect for those who can benefit from the tax deferral or want to lower income taxes on their Social Security benefits (this includes millions of Americans and is growing daily). Annuity earnings are not counted in the combined income formula that determines the taxes on Social Security benefits. What's more, if you're now saving for retirement and know you won't need the money for, say, ten years, you'd be nearsighted not to consider an annuity because it is safe, gives you current income tax relief and doesn't take a lot of money to open an account. Notice I said "consider" rather than "buy" because I have no idea if an annuity is suitable for you without knowing your unique circumstances.

Another example is someone already retired who knows they won't need some of their money until the last half of their retirement—as long as 15 or 20 years from now. An annuity would give them the safety of knowing their money will be there when needed, will earn a market rate of return (or better), and income taxes will be avoided on the earnings until they actually withdraw the money. Pretty powerful reasons for considering annuities for some of your retirement money! But again, they may not be for you if you'll need your money sooner, your combined income is below the taxable level or you just really enjoy something with more excitement.

Sometimes you'll hear a self-professed financial expert say that qualified money (IRA, 401(k), 403(b), TSP and the like) is not appropriate for annuities because it already has tax deferral. This is simply not true. Granted, you already have the tax deferral, but to focus exclusively on the tax deferral characteristics of annuities is to ignore their other benefits: an opportunity for a higher rate of return, the ability to convert the money into a monthly income you can't outlive, or penalty-free access that other alternatives simply don't have. When putting your hard-earned money in savings or investments, the litmus test is "how much will I earn" and "how safe is my money." If an annuity beats the other options, and oftentimes it does, then it's okay even if you don't plan to use the tax deferral feature of annuities.

Generally, the people who tell you never to put tax deferred money into an annuity don't know anything about them or have an interest in selling you something else. "Never" is a word that should *never (oops)* be used when it comes to investments—but there are always exceptions. Annuity bashers invariably suggest you should put your money at risk in the market in the hopes of earning more. Or they suggest that all money is best kept in low-yielding bank CDs. You'll usually discover these advice givers to be bankers, stockbrokers or financial columnists. The fact is most people just don't understand annuities. Many of those who claim expertise are biased because they sell other investments and would rather bash annuities than compete with them. Among the investing public, knowledge about annuities is not widespread. In fact, right now you know more about them than 95% of the people in America.

Who Should Not Buy an Annuity?

Okay, we've discussed who can benefit from an annuity. How about who cannot benefit? Younger people (typically less than age 45) who have several more years to work and who rarely, if ever, think about retirement issues are generally better off with more risky investments. Why is that? Risky investments over very long periods of time generally do better than low risk investments like annuities and bank CDs *if they are held for a long time [however this has not been the case in the past two decades]*. These young people have "time" for market recoveries, "time" to adjust their savings rates and "time" to modify their lifestyles. Because they work, they also have a steady income that will continue for years to come. In other words, they can take more risk than someone in or near retirement because they have more time. That said, some young people are wise beyond their age and know that the risk of principal loss leads to loss of sleep. They prefer to sleep soundly rather than to risk in hopes of making an extra few bucks in earnings. But typically, 40-somethings aren't thinking about retirement because they're rushing around trying to make ends meet in a world of rising prices and shrinking time. Therefore, annuities are more commonly the choice of their parents and grandparents.

If you'll need your money before the end of five years, it is generally not a good idea to use an annuity unless it is an immediate annuity that pays you an income. You'll want to keep money needed near-term in a safe place where it can be withdrawn on short notice without penalty. While this strategy may result in you earning a lower rate of interest than if you chose an annuity or bank CD or other investment, you'll also avoid early withdrawal penalties and/or the risk of market losses. While this might sound logical to you, I am constantly amazed that people in or near retirement either have all their money in very liquid investments or totally exposed to market losses in hope of scoring big. There does not seem to be a matching of investment maturities with the expected time of use: this is exactly what is needed by most retirement-minded folks.

Sometimes it is concluded that you should not invest in an annuity if your tax bracket is very low or your money already has tax deferral. You simply don't need the tax deferral! While you don't need the tax favored benefits of an annuity, it is wrong to conclude that annuities are bad for you because annuities have other features and benefits in addition to tax deferral. Certainly if you don't need the tax deferral you'll want to make certain that one or more of the other features of annuities will be of benefit to you.

Who Sells Annuities?

The most common places to buy annuities are banks, brokerage firms, insurance agents and financial planners/advisors. Generally, you can't buy annuities directly from insurance companies even though they are the only businesses that underwrite and issue them. Why? Insurance companies, unlike banks and brokerage firms, typically don't have branch offices because they use independent agents who own mostly small insurance agencies—sometimes just one or two person offices. So if insurance companies sold annuities directly, they'd be in competition with their own sales force which would not be a smart move if they want to keep their sales force happy.

By letting independent businesses take the risk of distributing their annuities, insurance companies can avoid all the expenses associated with these remote offices and employees which means they can operate cheaper. This is really good for you, because they can also sell cheaper (in other words you'll get a better deal on annuities than if they were delivered out of fancy offices owned by insurance companies). Maybe that's why bankers pay you next to nothing on your deposits and charge you 18% on credit cards, and why brokerage firms have to sell you something even when the market tanks. Makes sense to me, how about you?

When it comes to the sale of annuities, regulators from both the state and the FINRA (a self-regulatory agency that monitors the securities industry) have oversight responsibilities. Anyone who offers you annuities must hold an insurance license issued by their state and, in some cases, must also have a securities license issued by the FINRA. To obtain these licenses, the licensed representative must pass one or more examinations, clear a criminal background check, carry errors and omissions insurance, take continuing education classes, pay license renewal fees, follow a code of ethics, and abide by the laws and regulations governing their industry.

This level of scrutiny helps protect you from unscrupulous people who are out to separate you from your hard earned money. Does this mean you can trust someone with your money just because they hold an insurance or securities license? No. I've always found it best to get to know those who provide services *before* the providing starts, and buying an annuity is no different. Of course, it will also help if you learn as much as you can about annuities beforehand, so please continue reading.

Types of Annuities

I've tried to explain that buying an annuity will not lead to your financial ruin, but at the same time caution you that they're not for everyone. Annuities have many attractive features that help lots of people enjoy a better life, especially if they are retirement-minded. But they have limitations and like all investments and savings, no single financial instrument is perfect for everyone. To determine which combination of features and benefits might be best for you, we need to dive into more detail. Also, if you already have an annuity you'll want to know what you really own because, as we all know, the devil's in the details.

Income or Immediate Annuities

As the name implies, this type of annuity guarantees a stated income for a set period of time or for your lifetime. The monthly, quarterly, semi-annual or annual payments you'll receive are determined by the amount of money you deposit with the insurance company, your age, your gender, current interest rates and sometimes by your expected remaining lifetime.

If you choose an income for the remainder of your life, the insurance company guarantees that it will last as long as you do. Also, they automatically send you a check each month (or quarterly, semi-annually, etc.) or send it directly to your bank account or anywhere else you want it to go. What's more, you can select a joint lifetime so it pays as long as either you or your spouse is alive. The payments can remain the same when the first person dies, or you can elect to have a lesser amount paid.

You can elect to have a "period certain" income lasting anywhere from a few years to as long as 30 years. Also, you can choose many other options that make the annuity fit your individual needs. In fact, some companies will custom design an annuity for you if you're committing a sizeable amount of money. (When lawyers settle lawsuits, they often request and get custom-designed annuities to fund their structured settlements.) Generally, once you start receiving the payments on an income annuity, they cannot be stopped or converted into a lump-sum amount of cash. However, there are a few exceptions you should ask your financial advisor about in case you ever change your mind. For that reason, you should not purchase an income annuity if you think you might need all your money at once before the annuity maturity date.

If you deposit a lump sum of money in return for a series of guaranteed future payments, the money in your account not used for the income payments will grow tax deferred. Similarly, if you convert an existing annuity into a stream of future payments, the previous earnings will continue to be tax deferred until all the money is paid out or until death occurs. Each payment from an income annuity includes a return of principal and earned interest. So there are significant tax advantages to the income you'll receive from your immediate or income annuity. This favorable tax treatment of an income annuity can add up to a substantial sum over the lifetime of the guaranteed payments, and it can make the after-tax monthly payments from an income annuity higher than the same amount of money put into a CD. If you now live on the interest from your bank CD, you'll want to investigate this possibility.

You can even split your money between an income annuity (which could pay you a monthly income that is tax advantaged), and a fixed annuity (we'll discuss this type of annuity in just a moment). So when the income stops from the first annuity, the other tax deferred fixed annuity has grown back to the original amount, or even greater. As you can imagine, the income annuity comes in handy for retirees wanting to make sure they never run out of money during their lifetime or the lifetime of their spouse. Since some of the income represents return of your principal, you have a lower tax bill than if you get the same income as interest from a bank CD. (This does *not* apply to qualified retirement plan assets like IRAs and 401(k)s on which you've paid no income taxes.

There are generally no medical tests or other requirements for income annuities as the payments are based on the amount of money you deposit with the insurance company, current interest rates, gender and the ages of the individuals who will receive the payments. If you have a history of poor health and think an income annuity fits your needs for a lifetime income, be sure to ask about medically underwritten income annuities. This means your health will be taken into consideration and you may get *higher* income payments because you're not expected to live as long. Not all insurance companies offer this type of annuity, so if you want a lifetime income and you're not in the best of health, it pays to shop around.

Other uses of the income annuity are for structured payments to lottery winners, lifetime benefits awarded in personal injury lawsuits, long-term financial commitments such as alimony, child support, or any other contractual obligations that require future payments be secured. For example, people often use income annuities to pay life insurance and long-term care insurance premiums. Another important consideration: there is generally no out-of-pocket commission paid by the buyer of an income annuity, and 100% of your money goes into the annuity.

Traditional Fixed Annuities

Annuities designed with a set rate of interest paid for one or more years are called traditional fixed annuities. They're similar to bank CDs in that they offer a fixed rate for a set number of years or the contract term. When the contract matures you can withdraw your money lump sum without penalty. Some fixed annuities offer an interest rate that is tied to the movement of a stock or bond market index. These are called fixed index-linked annuities. But let's first talk about the traditional fixed version.

Traditional fixed annuities work a lot like bank CDs except they're guaranteed by the insurance company and not the FDIC. When you deposit money, you'll get a declared interest rate for a set period of one to ten years. However, you will pay a penalty if you change your mind and close the account before the contract term has ended. If held to term, the return of principal and earned interest is guaranteed by the insurance company. There are versions with guaranteed increasing rates for a set number of years, and ones with fixed rates for a given number of years and then changing annually thereafter. You may even be paid a bonus that will immediately increase your account value.

If you hold the annuity until the term expires, you can withdraw your money in a lump sum without a company penalty. With a traditional fixed annuity, you are generally allowed to withdraw a certain percent or amount of your money penalty-free before the end of the term. The "free out" provision means you can get at some of your money without breaking the contract or worrying about paying an early withdrawal penalty. This feature is generally not available in other financial alternatives where you keep your money unless you're willing to settle for a very low rate of interest as in a bank savings account or money market fund. This "access-to-your-money" feature allows you flexibility in withdrawing a portion of your money without penalty before the end of the term. Many fixed annuities also provide for a lump-sum or large withdrawal in cases of medical emergency, diagnosis of terminal illness or upon entering a nursing home or hospice. Almost all fixed annuities guarantee you some minimum rate of return if the initial fixed rate is not guaranteed for the full contract term.

Fixed Index-Linked Annuities

Fixed index-linked annuities *(FIAs)* receives frequent bad press because the stock brokerage community is not overjoyed with their popularity. They're popular because they provide attractive features not available from securities. FIAs guarantee you'll earn an interest rate linked to a major market index, but you will not suffer a loss if the market plummets. Brokers who offer stocks, bonds and mutual funds can't offer this downside protection on their securities, and they're none too happy about having to compete with the index-linked annuity. Even a few journalists, bankers, and securities regulators will deride FIAs for this very reason. But, in almost every case they cite as an example where a person was sold something that was just not suitable for their needs. What they fail to say is that such people should not buy *any* annuity or *any* security because they need all their money for living expenses or emergencies. So, the argument is typically not with the product, but with the people to whom it is sold. The facts are twisted to support their biases.

The truth is many of the harshest and most vocal critics of FIAs are really just worried about the commissions they've missed because of the market share they've lost to these products. Here's why: FIAs are similar to traditional fixed annuities except rather than being paid a fixed rate of interest you will earn a rate of interest determined by a stock or bond market index. For instance, the index to which your earnings are linked might be the S&P 500 stock market index. Your interest may reflect less than 100% of the change in the index if it goes up, but if it declines, you will not share in the loss. (Changes in the index will not include dividends paid on the underlying stocks.) For example, if the index increased by 15%, you might only get a return of 8% or 10%. But if the index sank by

15%, you would not suffer a loss. That's why FIAs are so appealing to those who hate losing money. The upside opportunity with no downside risk is very attractive to some savers who want the potential for a higher rate of return but without the risk of loss. Once you earn money in an FIA your yearly gains are locked in and retained never to be lost even if the market nosedives.

When you purchase a FIA, your money is not in the market and not exposed to market risk. However, your rate of earnings is determined by the growth in the market index. FIAs have been characterized as a simple concept made complex by insurance companies. It's easy to let the "moving parts" of some FIAs overwhelm you, but I'll try to simplify these in the discussion to follow.

Fixed Annuities with Income Benefits

Some annuities have incorporated the features of both an income annuity and a fixed deferred annuity by allowing you to lock-in a lifetime income after you reach a certain age, generally at least 55 or 60. This optional feature may be available only by paying a fee or by accepting lower earnings, but you get a lot more flexibility than with an income annuity. If you think you might want to convert your money to a lifetime or period certain income in the future but are hesitant, you might benefit by making sure your fixed annuity has this extra feature. It allows you to lock-in a guaranteed lifetime income at some future date but retain control over your money by starting, stopping or storing the income payments. This new variant of fixed annuities is gaining favor with retirees and other retirement-minded savers. Personally, I favor this new design feature over income or immediate annuities because it gives consumers much greater flexibility.

Variable Annuities

The next classification is variable annuities. As the name implies, the value of this annuity can vary over time just like a mutual fund or share of common stock. In fact, that's a useful way to think of the difference between a fixed annuity and a variable annuity. In the fixed annuity, the principal you invest is fixed but the interest can vary. In a variable annuity, your principal *and* your interest can vary.

Variable annuities are classified as "securities" and can only be sold by someone with both an insurance license and a securities license. Rather than your earnings being guaranteed at a set rate, they will be based on the value of the underlying assets, called sub-accounts, of the variable annuity. These sub-accounts are generally stocks, bonds, or mutual funds. If they rise in value, you could make a very handsome return. If they fall in value, you could suffer a sizeable loss. Generally, they are either rising or falling and that's why they're called "variable annuities" and why they're classified as "securities."

Unlike fixed and income annuities, variable annuities also generally have up-front commissions that you pay as well as on-going fees which come out of the principal if there are no earnings. In other words you can have the worst of both worlds: a declining value that is worsened by added fees. Somehow, paying someone to lose money for me doesn't make a lot of sense. For additional fees, variable annuities sometimes offer extra benefits like the ability to convert to a guaranteed lifetime income, get a minimum guaranteed interest rate or a guaranteed death benefit that is paid to your beneficiaries.

Variable annuities are generally best for those who can afford to take some risk of loss and have a longer time horizon for their investments. They do offer the same tax deferral features as fixed annuities and have been very popular with school systems who offer their teachers a pension program. In my opinion, the fees on variable annuities are generally too high for the benefits received. Mutual funds, in my opinion, are generally a better alternative if you don't need the tax deferral. If you can benefit from the tax deferral, fixed annuities would be my choice because they're a lot less risky.

Features and Benefits of Annuities

If you've read everything to this point, you're almost an annuity pro. You should have a pretty good sense of what annuities are, how they work, and which, if any, might be suitable for some of your retirement nest egg. We will now dive a bit deeper into the terms and conditions of annuities to better equip you if you're considering the purchasing an annuity or already own one. While there are many provisions in the typical annuity contract, we'll concentrate on the major ones that separate the good annuities from the bad ones.

Insurance Company Ratings

Just like you go in for an annual physical, insurance companies are given an annual check-up for their financial condition. There are several companies that rate the financial strength of insurance companies, but the oldest and most recognized is A.M. Best Company which has been rating insurance companies since 1899. The highest rating they offer is A++, follow by A+, then A and so on down the line to F. The last investment grade is B++ by A.M. Best and I recommend you stick with B++ to A++ ratings. Maybe a bit too conservative but always best to err on the side of caution. Ratings of insurance companies are also assigned by S&P, Moody's and Fitch. Keep in mind that none of these guarantee the rating they assign, but they do have an excellent track record. In fact, I'd give these rating agencies an A for excellence in spite of the mistakes they made in rating mortgage backed securities leading up to the Great Recession of 2007-09.

Surrender Schedule and Period

The surrender period is the length of time you will incur a penalty from the insurance company for withdrawing more than the free amount allowed by your annuity policy. The length of the surrender period and the amount of the penalties vary by company and annuity. The surrender schedule is always stated in the policy as well as the consumer literature provided by the company. The only time surrender penalties come into play is when you withdraw from your annuity more than the penalty-free amount or terminate/transfer your policy before the end of the term you've agreed to. Generally, the closer to the end of the contract term the lower the surrender penalty.

For example, you may select an annuity with an 8-year surrender schedule that has a penalty of 8% if surrendered in year one, 7% in year two, and so on until it reaches 0% at the end of year eight. Thereafter, you can withdraw or transfer your money in a lump sum without company penalty. Bank CDs have similar penalties if you withdraw your money early. These are usually expressed as so many months of interest. Unlike annuities, bank CDs do not generally allow for partial withdrawals of the account—it is all or nothing. A good annuity will waive the surrender penalty for the beneficiaries if the owner dies, is confined to a nursing home, is diagnosed with a terminal illness or has other medical emergencies. Also, a good annuity will allow you to stipulate how the beneficiaries can take the money after your death. Also, *any* investment can be placed in a trust where distributions are managed in accordance with your stated desire.

Generally, short surrender periods indicate a lower earnings opportunity. This is true for annuities as well as other safe saving places. I recommend you try to match the maturity of your annuity with the time when you feel you'll need the money. During your contract term, none of the earnings left in the account will be subject to income taxes. And at maturity, you can shop the market for a different annuity, or any other uses, that best suit your needs.

How long of a surrender period should you select? The answer depends on how long it will be until you need the money. If you have no particular plans to use the money, the surrender period is not too important because generally your heirs can get the money lump-sum without penalty upon your death. On the other hand, if you'll need your money in about five years, then your annuity should not exceed five years in surrender. That said, you should know the longer you're willing to commit your money to the insurance company the better the deal they'll generally give you. Bankers do the same thing: longer term CDs pay more than shorter term CDs. If you're uncertain of how long you can afford to keep your money invested, always err on the side of being too short rather than too long. As a reminder, you should plan on keeping an annuity for at least five years before you withdraw and use the money.

What if you'll need half your money in five years and the other half in ten years? Easy: put it in two annuities—one five-year and one ten-year (but be careful if you're buying both from the same annuity company in the same calendar year: I'll explain later). What if you'll need your money next year? In that case, an annuity is not for you. What about if you don't think you'll need it for ten years but you're not sure? Here's the dilemma: you'll get a better deal if you wait ten years, but if you need to withdraw all the money early you'll be penalized. Which is less painful: getting a slightly inferior deal by buying a shorter term annuity, or possibly suffering a penalty by buying a longer term one?

You can hedge your position by going for the longer maturity with two-thirds or three-quarters of your money and putting the balance in an interest earning bank account from which you can withdraw on notice. Also, you can put your money in a longer term annuity that permits you to annuitize, or take periodic payments, prior to maturity. Or you could determine how much the penalty will be and decide if you can afford that risk. Remember: the longer you hold your money in most annuities, the lower the surrender penalty and less punishing the penalty will be if you withdraw early. Or said another way, the longer you can go without withdrawing your money early, the lower the risk of being penalized. Choose a penalty level you can live with, and shorten up the maturity of your annuity by a couple of years. Of course, you face the same risk when you buy a bank CD with a term longer than a few months. The ideal way to confirm what is best for you: find and use a qualified financial advisor who will help you make the right decisions.

Market Value Adjustments

When you purchase a traditional fixed rate annuity, the insurance company guarantees to pay you an interest rate (it can be fixed, changed periodically or index-linked), and you agree to leave your money with them for a certain number of years. They rely on you to keep your commitment, and they invest your money accordingly. If you change your mind and want your money early, they will have to sell their matching investments or issue another annuity to replace the money you withdrew early. If interest rates have risen since you purchased the annuity, they'll have to pay someone else a higher rate to replace the money you withdrew or sell their investment at a loss (when interest rates rise, the fixed-interest investments fall in value). They will then penalize you with a market value adjustment to recover their higher costs or loss because you withdrew your money before the contract ended (the amount of the penalty is determined by a complicated mathematical formula). On the other hand, if rates have fallen when you withdraw your money early, the insurance company can replace the money cheaper or will make a profit when they sell their investment. Accordingly, you will earn a bonus in the form of a positive market value adjustment even though you withdrew early.

The market value adjustment (MVA), bonus or penalty, is added to or subtracted from the surrender penalty when you withdraw early. Not all annuities have this feature. If you think interest rates are going to fall in the future, you might want to choose an annuity with an MVA. But if you think rates will rise, avoid the MVA. How will you know if rates are going to fall or rise in the future? If you figure this out you'll be the first to do so in the history of mankind. Of course, if you hold the annuity for the contract term, you don't have to worry about it.

The original purpose of the MVA was to lessen the length and level of the surrender penalties, but that is rarely the case now. You will probably be better off to avoid annuities that have MVAs because if rates have fallen you would not want to surrender because the bonus you get will not compensate you adequately for the higher rate you're earning. On the other hand, if rates have risen, you just might want to surrender to take advantage of higher rates. Since you can be assured that the formula used to determine the MVA is always more favorable to the insurance company, it is probably best you avoid annuities that have surrender penalties plus an MVA.

Bonuses

Some annuities offer an interest rate or premium bonus when you open the annuity account. For example, you could choose an annuity that pays a 10% premium bonus up-front for a $100,000 opening amount. Your annuity account would then start out as $110,000. The bonus doesn't necessarily mean you're getting a bargain nor does it mean you're not getting a bargain.

The annuity salesperson may present the bonus as a way to compensate you for the penalty you'll suffer when transferring your money early from another investment (like a bank CD or another annuity). The appeal is that you won't lose anything by transferring your money. However, be aware that over the contract period you may receive a slightly lower earnings rate to compensate the insurance company for the bonus they gave you up-front. But if you think about it, even if an upfront bonus reduces the rate you'll receive in future years, all other things being equal, annuities with bonuses are probably a better deal than annuities without bonuses. Why? Well, as my grandfather used to say, a bird in the hand is better than two in the bush. I'd rather have a sure thing now than a maybe thing later on.

In the final analysis though, you're likely to receive about the same earnings with a non-bonus annuity as a bonus annuity over your holding period. But, if you have the right to withdraw a certain percentage of your account value without penalty, you may have access to larger amounts if you got a bonus when you opened the account. Also, some bonuses are made part of the death benefits so your beneficiaries may actually get a larger benefit with a bonus annuity. Nonetheless, you'll want to select your annuity based on features and benefits other than just the presence or absence of a bonus.

FIA Interest Crediting Methods

At latest count, there were over 100 different methods used to compute how interest is earned from a FIA. Remember what was said earlier: index-linked annuities are a simple concept made complicated by insurance companies. The methods used to compute your interest rate is at the center of this complication. These different ways are mostly marketing sizzle used by the insurance company to make their products appear unlike all the others. So don't pay much attention to them when reviewing annuities. Of course, once you hone in on the annuity you want, make very sure you understand how the crediting works. Keep asking questions until you've "got it."

All crediting methods are designed by actuaries to give about the same results over time. So, there is no way to tell beforehand which method is going to do the best over the next several years. Your financial advisor may say, and honestly believe, that one method is historically better than another. Empirical evidence proves otherwise! You should know that empirical evidence is generally based on research by very smart people, including actuaries. So, whether you choose point-to-point, monthly averaging, daily average, S&P index, DJIA index or others, your chances are about the same at the beginning because that is how the actuaries designed the annuities. Once your annuity starts, the different crediting methods will perform differently, and some will be better than others. But you will only know this after the fact.

The best approach is to hedge your opportunity by dividing your money between two or three of the crediting methods rather than selecting only one. This diversification means that over time the performance will average out, and the overall result will be more stable. Think of comparable fixed annuities as "commodities", because over the long run, they will all give you about the same results for equally rated insurance companies. Just for peace of mind, you might want to ask for the historical record of how an annuity has performed. But keep in mind that "back testing" an annuity can yield results that may or may not accurately reflect historical performance. There's an old saying in economics about getting the results you want: "just torture the data until it confesses". Also, past performance is not a reliable indicator of future results.

Death Benefits

No one likes to think about this unhappy topic, but what happens to your money when you pass away is usually very important to both you and your beneficiaries. Generally, the insurance company will allow the beneficiary to take the account value in a lump-sum or in installment payments over, at most, five years as this is the maximum time allowed by the IRS for non-pension money. Of course, a spouse can generally continue the annuity "as is" and become the owner. If an annuity imposes the surrender penalty on withdrawals by beneficiaries, I'd recommend you look for a different annuity. One of the advantages of an annuity is that your money generally passes to a named beneficiary without going through probate. This is just one more important reason why the money in your annuity should be available in a lump sum and without delay upon your death.

Penalty Free Withdrawals

Almost all annuities provide you early access to some of your money through limited penalty-free withdrawals. Generally, you can take up to 10% of the value each year, sometimes as early as the first year, without surrender penalty. You should avoid annuities that limit your total withdrawals to a certain percent of the original amount you paid into the annuity unless the withdrawals can be taken later if missed in one or more years.

Some annuities permit you to accumulate your withdrawals and take them all at once. For example, the annuity may allow penalty-free withdrawals of 10% annually, beginning in the first year; if you don't take a withdrawal in the first year, you can take 20% in the second year. If nothing is withdrawn during the first two years then you can get 30% in year three, and so on. This cumulative feature is frequently limited to a certain overall percentage of the annuity's value.

A few annuities offer very generous liquidity during the surrender period, especially if the annuity is not performing as expected. Generally, the more generous the liquidity the better, but make sure you're not paying extra for access to your money that you won't likely need. As stated earlier, you should avoid putting money in an annuity if you'll need access to it before the end of the annuity term. Many annuities allow you to withdraw all or part of your money early without penalty if you are confined to a hospital or nursing home for a stated period of time. Also, some annuities provide partial or complete withdrawal without penalty if you are diagnosed with a terminal illness and given one year or less to live. A few annuities permit you to withdraw your money free of penalties if you are involuntarily unemployed for a stated period of time. These may stop at a certain age and may not be available immediately, so be sure you read carefully the conditions.

Also, if your money is qualified and subject to IRS-mandated minimum distributions, most annuities, but not all, will allow these required withdrawals without penalty. Sometimes there are other provisions for free withdrawal before the end of the annuity contract term. So again, be sure you read and understand your policy's provisions for the various ways that you can withdraw your money early without penalty.

If at the time of purchase you are certain you'll need your money before the end of the contract term, you should either not purchase the annuity or purchase one with a shorter term. This is especially true for those younger than age 59½. Have your financial advisor write down, sign, and date all the ways you can withdraw early without penalty, and then keep this document safe with your annuity contract. In lieu of this document from your financial advisor, you can read and highlight the literature provided by the annuity company.

Most annuities will allow you to "annuitize" your annuity after a set number of years. To annuitize means to take equal installment payments over a certain number of years or over your lifetime. A common feature of an annuity is to allow annuitization without penalty over a five or ten-year period after, say, the fifth contract year (the period could be sooner or later). This means you can turn your annuity into a guaranteed stream of income for virtually any period you desire, including the rest of your life. Your income payments may be tax favored because only that portion of the installment payment representing the interest you have earned will be taxed. The other portion of your payments is considered a return of principal and will not be taxed unless it is a qualified pension account on which no taxes have yet been paid. You'll have all kinds of options for how, and how long, the income stream will last. These options will be listed in your policy, or you can call your advisor or the insurance company directly for help. If you want higher payments, you'll want to choose a short payout period. Before annuitizing, be sure and shop the market for the best payout from carriers that meet your rating standards. It is always wise to get tax advice if you are going to annuitize over a period less than lifetime.

Spousal Options

Most annuities will allow a deceased owner's spouse to continue the annuity as if it were originally purchased by the surviving spouse. The best way to make sure you always get this feature is to "style" the annuity as joint owners. Doing so ensures that both spouses are joint owners; thus, if one dies, the surviving spouse will become the sole owner. Most insurance companies will allow you to style your annuity with any number of owners as well as name multiple beneficiaries. You can even specify unequal amounts for your beneficiaries and/or the time period over which the benefits are to be paid.

As indicated before, annuities generally bypass probate and in most instances are protected from creditors' claims. Some professionals find the creditor protection feature particularly attractive because it helps protect them from legal judgments. However, the laws vary by state and you may wish to get legal advice to determine if your annuity is creditor and judgment proof.

If your IRA or qualified money is in an annuity, you'll want to pay special attention to how you structure the beneficiary designations because there could be unwanted tax implications. Be sure to talk with your financial advisor about "stretch IRAs" and "Roth IRAs" if you plan to put your qualified money into an annuity. Both of these can play an important role in your retirement plans and you will want to know about them.

That raises an important point: it is my opinion that most retirement-minded savers and investors who manage their money without professional help are making a mistake, because there are simply too many options to consider. In fact, my experience is that you'll make a better return, avoid unsuitable risk, save more taxes, sleep better, and enjoy your retirement more if you get professional help *before* investing your hard earned retirement nest egg. I believe that one of the biggest risks many retirees take is going it alone without professional advice.

How are Annuities Taxed?

During the growth—or accumulation—phase of annuities, there is no income tax impact on earnings because they are deferred until you actually withdraw the money. This is one of the most powerful features of annuities because it gives rise to the triple compounded interest I explained earlier. Simply put, you’re money will grow faster without the tax leakage—even if you pay all the taxes lump-sum when you use the money.

When the earnings are withdrawn, they become taxable as ordinary income. Annuities do not qualify for capital gains taxation. Furthermore, non-qualified money in an annuity is taxed on a last-in, first-out basis. This means that all withdrawals are considered to be interest until you withdraw down to the amount you initially put into the annuity. The term “non-qualified” means the money is not in a retirement account like an IRA, 401(k), 403(b), TSP, etc. Non-qualified money in an annuity that is annuitized over your remaining lifetime will allow you to spread the taxes on your earnings over your remaining lifetime rather than the last-in, first-out rule being applied.

The IRS has ruled that if you purchase two annuities from the same insurance company in the same calendar year, they will be treated as one annuity for tax purposes. This condition does not apply to income annuities, but it is important to remember if you have purchased—or are thinking about purchasing—two non-income annuities from the same company in the same year (this does not apply to qualified retirement plan assets). In such cases, the IRS might declare that all the interest for both annuities would be included in the surrender of one of them, meaning your taxes could rise.

Income annuities are taxed a bit differently because only the earnings are taxed, not the principal. This means that each installment payment is part earnings and part return of principal which translates into a smaller tax bite than if the same income is from a taxable place like a bank CD. There the income stream is all classified as “interest” and is all taxable. Of course, if the money in your annuity is qualified retirement plan money on which you have not paid the taxes, then all of the installment payment will be taxable income. This small and sometimes unnoticed difference can be very important because you may be able to get more income from a given amount of money by putting it into a combination of fixed and income annuities than if you keep it in a bank CD. So, if you’re among the millions of retirement-minded people who are living off CD interest, you might want to consider using a combination of income and fixed annuities to give you the same income from less money or more income from the same amount of money.

As long as the earnings stay in your annuity, no income taxes will be due and you will not get a 1099 interest statement at year-end. Furthermore, there is generally no requirement that you ever take money out of an annuity during your lifetime. At your death, your annuity will pass to your heirs and they, or your estate, will be responsible for the income taxes on any earnings that have grown tax deferred. With some other investments, beneficiaries get the “step up in basis” upon death of the owner, and no taxes are due. Annuities do not get this “step up” benefit, and taxes will be due on the growth portion when received by the beneficiary. If your annuity is structured as a qualified retirement plan, your beneficiaries will have more flexibility and can “stretch” the taxes over their remaining lifetime. If you have a great deal of money and are worried about how your estate will be taxed, you should seriously consider obtaining professional financial advice so you can prepare a plan to keep your money out of government hands once you pass on.

Sales Loads

As mentioned earlier, income and fixed annuities—but not variable annuities—generally do not have a broker’s commission that is paid directly by the buyer. All costs and fees are incorporated into those annuities just as they are in a bank CD. The insurance company pays the licensed representative a commission for selling the annuity, and they recover the commission expense over time from profits they make by investing and managing your money. This means that 100% of the money you put into an income or fixed annuity will earn interest or be used to pay you benefits.

Variable annuities, on the other hand, generally have sales loads or commissions which are taken from the principal you invest, so less than 100% of your money goes into the account. Also, variable annuities have numerous annual fees that are taken from the account—even if the account loses money during the year. If you are thinking about buying a variable annuity, be sure you identify all the different costs and fees. Also, compare the expense ratio of the variable annuity you’re considering to other annuities.

By the way, the selling broker can generally select one of several ways to get paid—such as a larger up front commission at the time of the sale or smaller amounts over time as long as you hold the annuity. If your broker is taking a commission from the insurance company *and* charging you an annual amount for managing your money, you might want to consider looking for a new financial advisor. In my opinion, such double dipping is over the top, and you’ll be paying more than you should. On the other hand, don’t expect a competent financial advisor to work for nothing. They offer valuable services, and it is only equitable that they be fairly paid. The same is true for the insurance company.

Insurance companies are in business to make profits, and they do it by paying you less than what they earn on your money and by managing the risks you don't want or need. Of course, they combine the money of many small savers and investors to make large investments that generally earn more than you could earn by taking the same amount of risk. In short, insurance companies add value by managing investment risk and by earning more from their sizable investments than would ordinarily be available to individual consumers.

Participation Rates, Caps and Spreads

When you purchase a fixed index-linked annuity, your money is not invested in stocks or the market. While there is nothing wrong with this, some people think their FIA assets are "in the market" and, therefore, at risk. But that's not the case. The rate of return you will receive is determined by the movement in the index to which it is linked. You generally will not get 100% of the increase in the index. This less-than-100% participation is the price you pay for *not* sharing in losses when the market declines.

The "participation rate" is the percentage of the index increase you will receive. Further limits are sometimes placed on FIAs by putting a "cap" on the amount you can earn during a stated period such as a month or year. For example, you may have a participation rate of 100% but the annual cap will limit you to 8% or 10% growth. The rest, if any, goes to the insurance company as compensation for guaranteeing you will not participate in market losses. Sometimes the crediting method uses an average which effectively limits your participation rate to less than 100%. Caps are relatively rare when averaging is used. Annuities that have both a participation rate less than 100% *and* a cap should generally be avoided. Remember, either a cap or less than 100% participation is okay, but both in the same annuity should serve as a red flag.

Insurance companies mix and match caps, participation rates, and their methods for measuring changes in the underlying index to create different crediting techniques. This makes their annuities appear different from the competition. The "point-to-point" crediting method generally measures the index at a beginning time, measures it again at a stated ending time, and then applies the participation rate to determine the amount of interest to credit to the annuity. While the time lapse between the two points can be as short as one day to as long as ten years, the monthly and annual point-to-point crediting methods are the most common. Generally point-to-point crediting methods have participation rates of less than 100% and no caps, but not always. The averaging method also comes in daily, monthly, annual and multiple years. The interest rate is determined by averaging the ending value (daily, monthly, etc.) over a month, year or longer to determine how much interest to credit to the annuity.

Averaging generally, but not always, uses a cap to limit the increases, but not the decreases. Also, it effectively limits your participation rate to about one-half. To see this average the numbers 1, 2, 3…. 12. You'll see the answer is 6.5, or half-way between the lowest and highest number. Why should that be important to you? Because, you should be aware that a monthly average crediting method giving you 100% participation is not necessarily better than a point-to-point crediting method paying you 50% with no caps. Remember, crediting methods are used by insurance companies to differentiate their annuities. Ironically, many honest advisors are totally convinced that one crediting method is always better than the other. But, as evidenced above, this simply isn't the case.

"Spread" is insurance-speak for "fee" and generally means the company will take a certain amount from your gains before they credit your earnings. For example, a spread of 1.5% means that the insurance company will subtract 1.5% from your earnings rate before they credit your account. If the earnings are negative or less than enough to cover the spread, the insurance company won't be paid or will be paid less than the full amount.

If you're considering an annuity, or already own one, that has less than 100% as a participation rate, includes a cap, and charges a spread, you've got a bad annuity. Just remember that participation rates, caps, and spreads are all designed to make the playing field level between the various annuities offered by insurance companies. These limitations are generally not bad or unfair but simply give the insurance company a chance to make an operating profit from the money they are managing for you.

Fees and Expenses

With rare exception, all fees and charges are built into income annuities and fixed annuities. This means your opening account balance is 100% of the money you put into the annuity or more if a bonus is applied to your opening amount. Of course, if you decide to withdraw more than the free amount that is allowed each year before the end of your contract's term, you will incur surrender fees.

As I discussed before, sometimes a FIA will have a fee, called the "spread," which is an amount that comes out of your earnings to pay the management expenses of the account. Generally there is no spread charged if there are no earnings. Additional fees may apply for certain benefits such as the right to convert your annuity value to a stream of income at some predetermined point in time while retaining the right to change when, how, or even *if* you take an income.

Variable annuities are very much like mutual funds in that they often charge commissions associated with the purchase. Commissions can range from less than one percentage point to as high as several percentage points. These up-front sales charges are generally deducted from your money before it goes into your variable annuity. This means your initial account value will be less than the money you paid. In addition to the up-front charges, recurring annual charges are levied even if the variable annuity performs poorly. These other charges can run from less than one percentage point to more than three percentage points. In addition, there may be fees for "riders" that provide extra benefits, such as a guaranteed lifetime income benefit, a death benefit and others. Before selecting a variable annuity, you'll want to make sure you understand all the fees and charges. It is best to add them up to arrive at an annual total. For example, if the up-front sales charge is 5%, then only 95% of your money will be credited to your account. If the recurring charges are 3% of your account value annually, you will have to earn more than 3% for the account to grow. Remember, fees on variable annuities are imposed even if the account loses value.

Where can you find a list of these fees? Since a variable annuity is a security, you'll be given a prospectus which you must acknowledge you have read. The prospectus will detail most fees you'll be charged. Granted, you'll have to do some digging to find them but they're there. By the way, the prospectus is the bible in case of disputes. So read it! If you don't understand it, be sure to ask the variable annuity company or your financial advisor for clarification.

Also, should you withdraw your money from a fixed or variable annuity before age 59½, you could be assessed a tax penalty of 10% of the earnings by the IRS. Remember, annuities offer tax deferral that was authorized by Congress to encourage you to save for your retirement years. If the money is withdrawn before age 59½, your earnings might be subject to the IRS penalty tax. Any remaining earnings will be subject to ordinary income taxes just like interest from a bank CD. Accordingly, money put into an annuity should be for the long term—five years or longer—and not withdrawn before age 59½, except for emergencies. If you decide to retire early and agree to take your money in substantially equal payments for at least five years or until you reach age 59½, whichever is longer, you can avoid the 10% penalty tax from the IRS. There are other legitimate strategies to avoid this 10% penalty tax that you'll want to explore with your financial advisor before you take early withdrawals from your annuities.

Who Bears the Earnings Risk of an Annuity?

Income Annuities

The risk is borne by the insurance company because you are guaranteed a stated income for the chosen period regardless of what happens to interest rates, the securities markets, or any other factor. With an income annuity, you deposit a fixed sum of money and get a fixed guaranteed payment. The insurance company pays you installment payments for the period you have selected, including the remainder of your life and your spouse's life if you chose that option. If interest rates rise or fall during the payout period, the insurance company will either be the winner or loser, not you. If you live longer than expected, the insurance company is still required to pay. (How can they afford to do this? Those who live too long and result in losses for the insurance company are offset by those who die earlier than expected which results in a profit for the insurance company.)

Since insurance companies have many policyholders, the risk they take is easy to manage because they base their pricing on mortality tables. The "law of large numbers" is the principle underlying all insurance and has worked successfully for centuries. This conservative operational strategy and the same law of large numbers is why insurance companies rarely go broke. Social Security could benefit by operating their affairs like an insurance company, but that's not likely to happen because of their management team—the government. Imagine how much money you would now have if you had paid into an annuity rather than Social Security. Incidentally, most fixed and variable annuities allow you to make additional payments. You can have these payments sent automatically by having the insurance company draft your bank account, or you can simply send them checks yourself.

Fixed Annuities (Including Fixed Index Annuities or FIAs)

Again, the risk is borne by the insurance company. With a traditional fixed annuity, you are guaranteed a fixed rate of return for the number of years selected and the insurance company is obligated to pay that amount. With a FIA, the interest rate is tied to a market index which determines the interest rate that is earned. But, if the index to which the annuity is linked goes down, your account value will, at worst, earn nothing but will lose nothing as well. Think of this as an investment with an air bag: if the market crashes you'll not be injured. With FIAs, the worst case scenario is you'll earn the minimum interest rate guaranteed if you hold the contract to term. The minimum rate guaranteed by an insurance company varies by state (remember insurance companies are regulated by the state where they're located). Generally the rate is somewhere between 3% on 100% of your money to as low as 1.5% on 87.5% of your money. Guaranteeing a minimum rate on less than 100% of your money can be very misleading. Here's an example: How much will you earn if you are guaranteed 3% on 90% of your money? The obvious, but wrong, answer is 2.7% (3% times 90% = 2.7%). If you do the arithmetic you'll find that 3% on 90% over five years is 0.8523%, and over ten years the rate is 1.9205%. I've even had financial advisors tell me that 3% on 90% is equal to 2.7%, so don't feel bad if you were fooled, too.

Variable Annuities

The risk of loss is a risk you take, not the insurance company. The underlying investments of a variable annuity are generally stock, bonds and mutual funds. If their value decreases, you will realize a loss because your account value is determined by the value of the underlying sub-accounts, and recurring fees are charged even if the account loses value. You may be able to purchase a “rider” for an extra charge that will guarantee your account value will rise by a minimum amount each year. However, this guaranteed value is available only if you convert the annuity to a lifetime income or die before the payout phase starts. Many times you will be told that the variable annuity will guarantee you a 7% (or some other percentage) return, but this may not be explained fully. The guaranteed return is the account value that is used to determine your lifetime income if you choose that option. If you choose the lump sum option, the guaranteed return is no longer valid. Be sure and read the fine print on the rate guarantee before your free look period ends. Generally, there is no guaranteed account value of a variable annuity if you take the money in a lump-sum or transfer the money to another annuity. If you’re thinking about a variable annuity, you will want to check out mutual funds before you write the check. Yes, you’ll be giving up the tax deferral but the underlying assets are the same and mutual funds have much lower fees.

How Do You Know Which Annuity is the Best?

Unfortunately you don’t, and neither does anyone else before the fact. What’s more, the same is true with every other investment. Do you know which mutual fund, stock, bond or piece of real estate is going to be the best earner over the next ten years? Of course not, and the same is true of annuities. You can, however, generally tell which *type* of annuity is best for you and your family. If you need an income right now, then the option is an income annuity that pays you for a certain numbers of years, a lifetime, or a combination of these. Another option would be one of the new hybrid annuities that permit you to get an income immediately and still have the flexibility of starting, stopping and storing it.

If you do not want the possibility of down-side risk, then only traditional or FIAs held to maturity are suitable. If you can afford to take risk of loss, then you might also consider a variable annuity. When buying a traditional fixed or income annuity, we can’t look over the horizon and see where future interest rates will be. When you lock up your money in a fixed-rate bank CD, you never know if the rate guaranteed today will be fair tomorrow. Of course, the insurance company faces the same problem when they invest the money you entrust to them. By my way of thinking, if the insurance company is willing to take this risk, then that could be a good thing. And, that is exactly what happens with all annuities except the variable.

If you think (notice I said "think") rates will rise in the future and you are interested in a traditional fixed annuity, you'll want to choose a rate that resets every year to take advantage of the rising interest rate trend. If you feel (notice I said "feel") rates are headed down, you'll want the longest guaranteed rate available so you can lock in current rates. Since we can't forecast future interest rates, it is often wise to hedge your bet by investing your money in more than one maturity to make sure you get the average over time.

When it comes to income annuities, you would ideally like to buy them when interest rates are highest and avoid them when rates are lowest. But, at any given time we never know if today's rates are higher or lower than next year's. When rates are high, the insurance company will earn more from investments they purchase with your money and will in turn pay you more. But this is only part of the picture if you're buying a lifetime income because your age plays a role. The older you are, the less time you have to live and the shorter the time the insurance company will have to guarantee you an income. So, older folks receive more than younger folks for the same amount of money deposited into an income annuity. Also, women generally receive less because they're expected to live longer than men.

It is generally a bad idea to select a "lifetime only" option because at death the contract terminates, and any remaining money belongs to the insurance company. A good solution may be to select a certain period, say ten years, with a lifetime option. This combination means if you die within the stipulated ten years, your beneficiaries will continue to get payments for the remainder of the period. But if you live longer, you'll continue to receive payments until your death. You can also get this combination in a joint account if you want to protect your spouse.

Interest rates don't really play a role with FIAs because your earnings are based on an underlying index linked to the stock or bond market. And no one can forecast which way the securities markets are going to move over the next several days, weeks or years. The beauty of FIAs is that the insurance company takes the risk of market losses in exchange for giving you something less than all of the market gains. In addition, they guarantee you a minimum rate of return regardless of what happens. If this sounds like a sure thing, it is.

Which crediting method you select is the only risk you're taking with a FIA. And as I've mentioned, it isn't much of a risk because over the long haul they are all designed to be the same. Again, if you want to hedge this risk, divide your money among two or three crediting methods so you'll get the benefit of diversification. This "no loss" guarantee of FIAs coupled with the opportunity to realize superior earnings has proven to be a very popular savings place for conservative, safety-minded people socking away money for retirement or already in retirement and interested in keeping what they've got. What really counts is getting the triple compounding impact of tax deferral. The downside is that you have to commit to leave your money with an insurance company for five years or longer. In case of a major emergency, you can always terminate the annuity contract and withdraw your money, but there might be a penalty. Prudence dictates that you should only put money into an annuity you're pretty sure you won't need for the time period you've committed.

Is an Annuity Good for You?

It depends on when you'll need your money, your risk tolerance, the taxes you pay, your other investments, what you're trying to accomplish with your money, your retirement plans, and other factors that may be unique to you. Certainly an annuity, like all other savings and investments, is not for everyone nor is it bad for everyone. If you're trying to avoid the loss of principal, want a safe place to put your money until it is needed, would like to avoid taxes on earnings until you actually use them, want upside opportunity without downside possibilities, and can afford to keep your money invested until the surrender penalty ends, then an annuity is worth investigating. Many retirement-minded people have found that annuities offer many useful benefits without the usual disadvantages of other savings and investments. If you have a financial advisor, ask him or her to tell you about annuities and whether or not they are right for you.

A word of caution here: many financial advisors have not taken the time to learn about annuities and, therefore, don't recommend them even to people who can benefit. Likewise, the financial press is aligned with the brokerage community and often the information they provide about annuities is either biased or simply wrong. There is about as much controversy and confusion about annuities as there is about global warming and which political party is the worst. If your advisor says you should never buy an annuity, try the following test: tell him or her you have investigated annuities and found they are exactly what you need and you intend to invest in one. If your advisor then says that he/she can sell you an annuity if you really want one, you'll know they're more interested in making a commission than doing what is right for you. It's time for you to look for another financial advisor.

How do You Tell if Your Annuity is Good or Bad?

You have three options:

- First, compare your current or anticipated annuity with what I've said. This will give you an idea of its "goodness" or "badness."
- Second, you can consult with a professional financial advisor. Of course, you can do both of these by drawing your own conclusion and getting a second opinion from your advisor.
- Third, you can grade your annuity by using the Good/Bad Annuity Scale on the back page of this booklet. Obviously, this won't tell you if your annuity is right or wrong for you and your family, but it can tell you where your annuity fits on a scale.

What if You Have a Bad Annuity?

A bad annuity is one that is bad for you. This same annuity could be perfect for someone else but does not meet your particular circumstances. For example, I might be able to leave my money in a tax deferred annuity for 15 years because conservatively I've estimated that my other money will finance my retirement for 20 years. Accordingly, an annuity with a ten year surrender schedule would work just fine for me whereas a five year annuity would not generate the returns that I'm expecting. You, on the other hand, may not be as fortunate and feel like committing your money to an annuity for ten years is risky, because you feel that you could need the money in about seven years. Therefore, the ten year annuity is too long for you, but the five year is perfect. So what was good for me was bad for you and vice versa. I sincerely hope you don't have a bad annuity or one that is not appropriate for you, but if so you basically have two options:

Option One

You can transfer your money into another annuity that has friendlier terms and conditions by doing a 1035 Exchange. The "1035" refers to the section of the Tax Code which allows you to exchange one annuity for another without triggering the taxes on the earnings. If you transfer before the end of your surrender period, you'll be penalized by the insurance company since you initially agreed to a stated period. Make sure you can afford this penalty and that you have a good chance to make up the penalty with your new annuity during the remaining term of the old annuity. Bonus annuities may be a viable option when exchanging an annuity that is still in the penalty period.

Option Two

You can withdraw your money and put it in something that is not an annuity. If you are younger than age 59½ and the money being moved is non-qualified (that is, not part of a qualified retirement account such as a 401(k), 403(b), IRA, etc.), the IRS will levy a penalty of 10% of your earnings because annuities have tax advantages that encourage their use for retirement. The IRS wants to discourage those younger than retirement age from using their annuity money for something other than retirement.

Of course, if your annuity is still in the surrender period, you'll also pay penalties imposed by the insurance company. If you withdraw your money from an annuity, you'll lose the tax deferral and your annuity earnings will be counted as ordinary income during the year you received the withdrawal. By the way, you can avoid the 10% penalty tax of the IRS if you withdraw at younger than age 59½ but take substantially equal payments based on your expected lifetime for at least five years or until age of 59½, whichever comes later. This is called a 72(t) election and can be explained by your financial advisor if you're thinking about retiring prior to age 59½.

Conclusion

Annuities have been around for a very long time, and they have served useful purposes. With people living longer, an increasing number of retirees, and uncertain economic times, annuities will continue to add value for many by improving their retirement years. Like all savings and investment choices, they are not universally good for everyone nor are they bad for everyone. Annuities are worthy of your consideration and I strongly recommend you do not discount them without an investigation.

I hope this information has been valuable to you, and I thank you for helping me with my research.

Shelby J. Smith, Ph.D.
Revised August 2011
Houston, Texas

RATE YOUR ANNUITY

						Score
Annuity company rating	A++ or A+ 5	A or A- 4	B++ 3	Less that B++ 0		_____
Years of surrender	≤ 5 6	$>5, \leq 8$ 5	$>8, \leq 10$ 4	$>10, \leq 15$ 1	>15 0	_____
Value at death	Full 5	Reduced 2	Must take installments 0			_____
Up front sales commission	No 5	Yes 2				_____
Annual fees	No 5	Yes 2				_____
Account value fall if market falls	No 5	Yes 1				_____
Is there an MVA	No 5	Yes 1				_____
Is there a bonus	Yes 3	No 2				_____
$\geq$ 10% free withdrawal annually	1st Year 5	2nd year 4	N0ne 1			_____
Is RMD penalty free	Yes 3	No 1				_____
Medical waivers	Yes 5	No 2	Limited 4			_____
Are withdrawals capped as percent of initial premium	No 5	Yes 0				_____
My annuity is:	Income 12	Fixed 10	Index-linked 10	Variable 5	Hybrid 8	_____
					Total Score	_____

>60 = Excellent
≥ 56 = Good
≥ 52 = Medium
≥ 42 = Bad
<42 = Terrible

The foregoing rating system is for guideline purposes only and should not be interpreted as indicative of the suitability of your annuity. As you've learned by reading this publication, annuities have many features and benefits which make it impossible to precisely rank them on a good-bad scale. To determine the exact rating of your annuity and also its suitability for you, substantially more information is required. What's more, suitability can erode as you age or your financial circumstances change. Also, the suitability and acceptability of a given annuity can change in response to your individual circumstances as well as different economic and financial conditions. Furthermore, the introduction of new-design annuities can change the attractiveness of their predecessors. It is advisable to review with your financial advisor the suitability, features and benefits of your annuity at annual intervals.