## Annuities … The Good, the Bad and the Ugly

**Joe Delaney**

Too often, I've heard this all-too-familiar story. A client brings in an annuity policy to review, either for themselves or a family member. They bought it to create a steady annual flow of income on later life, as insurance against unexpected longevity.

But what we see is a jaw-dropping set of numbers that reveal poor performance, high commissions paid to brokers, misleading benefits and ridiculously high expenses. Unfortunately, too many investors purchase an expensive annuity that doesn't fit their needs.

How do so many fall into this trap? There are a few key reasons.

### Great for the Seller: Commissions

As an investor, the first thing to be wary of is the possibility that a broker, or agent, is pointing you in the direction of a product that's in their interests more than yours. Exhibit A is the annuity. An insurance product rather than a securities package, annuities are sold by insurance agents rather than brokers. It is sometimes the best option an insurance-only agent (not securities licensed) can offer.

There is nothing wrong with selling annuities, nor is there anything wrong with insurance agents earning commissions. However, when a product has particularly high commissions, it is all the more important to ask the agent directly whether annuities are in your best interests.

Strictly speaking, agents don't have to act in your best interests because they are not subject to federal fiduciary rules that govern financial advisors. They also pay out among the highest commissions in the financial service industry. The highest rates are paid for longer **surrender periods**, years during which policy holders are charged for withdrawals above the approved limit.

With so many common options that benefit the seller at the expense of the buyer, it can be tempting for unscrupulous agents to speak to the benefits of annuities while omitting the risks.

### Stability for the Buyer

The main benefit of the annuity is the option to guarantee a minimum return. Investors tend to fixate on the apparent risk-free nature of annuities as they plan to enjoy fixed payments after a pre-arranged waiting period.

In reality, this describes just one type of annuity, a **fixed annuity**. Similar to a Certificate of Deposit (CD), investors sacrifice the potential for a higher rate of return for the guarantee of a smaller one. Unlike a CD, there are generally complex fees and conditions attached to fixed annuities that reduce the value of the annuity.

For example, while tax is deferred as your annuity is accumulating, once you begin to withdraw accumulated funds you'll have to pay taxes at your ordinary tax rate rather than the lower, applicable, long-term capital gains tax rate. (If you invested $100,000, your annuity grows to $150,000 and you're in the 35 percent tax bracket. You'll pay 35 percent on the first $50,000 you take out, 20 percent more than on capital gains at 15 percent.)

**More Complex Options May Increase Return**

Other types include **indexed annuities** and **variable annuities**. These appear to offer the potential for higher returns: indexed annuities because the rate of return is tied to a specific market benchmark, such as the performance of the S&P 500; variable annuities because they allow premium payments to be reinvested, somewhat like a mutual fund.

Unfortunately, these types of annuities often have **performance caps** to offset the risk the firm takes on by guaranteeing a **performance floor**. These can significantly reduce expected returns. **Participation rate** is another factor that limits what investors earn, as it governs what share of returns go to the firm and what share goes to the annuity holder. (For example, a 70 percent participation rate means if the market gains 10 percent, your gain is 7 percent while the firm keeps 3 percent.)

The above limitations on rate of return don't take into account the additional premium investors must pay for **riders** to secure some of the benefits of these annuities, which further reduce actual return on investment.

**Bottom Line: Insurance, Not Investment**

Annuity performance often pales in comparison with a balanced portfolio of stocks and bonds, yet we routinely hear of "new and improved" annuities that insurance agents counsel clients to convert into, via a 1035 tax-free rollover. That only serves to fatten the agent's wallet while further locking up a client's ability to earn real income.

The good news is investors are starting to wise up to this. Annuity sales saw a 17% drop between Q4 2015 and Q4 2016. (It is still a $51 billion industry. So, investor beware.)

Does all this mean that you should definitely not purchase an annuity? No. What is important to understand is that while an annuity can act as a hedge against running out of income as you live longer, it is not the same as an investment portfolio geared toward the best possible return at the lowest possible expense.

Be cautious, and always speak with an advisor bound by a fiduciary obligation to act in your best interests before you purchase any kind of annuity.

## About Joe Delaney, Managing Director, Lifeguard Wealth, San Rafael, CA

Joe Delaney founded Lifeguard Wealth to help others realize their goals and dreams. As a fee-only financial advisor, he is dedicated to putting clients first. Joe has more than 30 years of financial-industry experience as a CPA and CFO; he has held senior positions with institutional investment and wealth management firms. Since 2001, he has focused his career on creating and executing wealth management strategies for individuals and families. He is licensed to provide investment advisory services, and he holds a BA in economics from Stanford University and an MBA in finance from UCLA Anderson.

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