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Variable Annuities: Explaining the Income Guarantee
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I have been in the financial services industry for close to eight years and frequently receive questions about, or hear comments regarding, annuities. One of the more common inquiries I get involves annuities with income guarantees: What are they? How do they work? And what are they actually guaranteeing?

In short, they are an insurance product in which an insurance company pledges to pay the contract holder a minimum stream of income sometime in the future. Of course, they tend to much more complex and nuanced in practice.

We'll start with an explanation of how variable annuities with a guaranteed income benefit function, and then discuss some of the potential pitfalls that including them in your long-term financial plan can present.

The best way to illustrate how variable annuities with a guaranteed income benefit work may be with an example. Let's say you have $500,000 and you purchase this type of annuity from an insurance agent or company.

First, the insurance company you buy it from will invest your money in a diversified portfolio of mutual funds that, in general, will own a mix of stocks and bonds. This money will participate in the market, much like investments you would hold in your 401(k) or IRA. Your money will be subject to market volatility and the value will fluctuate up and down. We'll refer to this value as your "walk away" money.

Second, the insurance company will provide you with a guaranteed amount of income from the annuity. We'll refer to this as your "benefit base." The benefit base will increase by a specific guaranteed amount each year, which is determined by the insurance company when the contract is issued. In this instance, we'll use 5 percent. The benefit base amount does not represent the walk away money you can withdraw from the annuity and spend. Rather, it is an accounting figure used to calculate the income you can withdraw from your contract on an annual basis. For the withdrawal rate, we will again use 5 percent.

So, for every year you hold the annuity product, your benefit base will increase by 5 percent until you decide to trigger your benefits (in other words, withdraw money). Let's assume you hold the annuity for seven years so your benefit base would have increased by 5 percent each year for a value of $703,550. Per our example, the insurance company has agreed to pay you 5 percent a year of the benefit base amount for the remainder of your life. That would equal $35,178 annually. This figure is the maximum dollar amount you are able to withdraw without adversely affecting your ongoing benefits or guarantee. Since you are now taking the 5 percent as a withdrawal each year, the benefit base remains the same at $703,550 going forward.

Now let's return to your walk away money. Again, this is the money that will be invested in the market and thus is subject to fluctuations. Continuing with our example and having held the annuity for seven years, let's assume that your portfolio had an average rate of return of 2 percent a year. That would now make the walk away value $574,000. If you decide that you no longer want to own the annuity for whatever reason and you wish to invest in another type of investment, this is the amount that the insurance company would write you a check for, not the $703,550 benefit base value.

In short, the guarantee is not a guaranteed rate of return on your principal. The guarantee is only for the income your investment will produce for you on an annual basis over your lifetime.

To really understand what these products mean for the long-term (such as when it comes to transferring your wealth to your heirs), we still need to dive a little deeper. Let's assume you end up owning this investment for 10 years. Over that period, we'll assume your walk away value still grows on average at about 2 percent a year. Like in the previous iteration of this example, you began taking income after year seven. With the benefit base at $703,550, you were able to take out $35,178 annually for three years, withdrawing a total of $105,534 before you (unfortunately) passed away. Your beneficiaries would then inherit approximately $500,000. How did we arrive at this number?

Well, the insurance company guarantees that your beneficiaries will be paid the greater of two amounts: your account value at the time of death (the walk away value of about $490,000) or the total of the funds you put into the account ($500,000) minus what you took out ($105,534) which equals roughly $395,000. In this case, the $490,000 was more than what you put into the account minus withdrawals, or $395,000. That means the actual rate of return at your death was about the same as the 2 percent returned by the actual portfolio.

But wait. I know a lot of readers are thinking at this point, "Hold on now. A 2 percent return is awfully low." So why did we use it? A lot of it has to do with the current market environment, where interest rates are at historic lows and stock market valuations are higher than average. A typical portfolio contains restrictions imposed by the insurance company on the level of risk an investor is permitted to take. Given these restrictions, many annuity contracts have an expected rate of return, before fees, of roughly 5 to 5.5 percent. This return is before costs, which can be a concern. The costs, on average, for this type of annuity contract look something like this: the mortality expense is going to run about 1.4 percent, mutual fund expenses will average approximately 1 percent, and the rider cost for the guarantee of income will also generally be 1 percent.

As you can see through this example, high fees and allocation restrictions are two examples of the pitfalls associated with variable annuities containing a guaranteed income benefit. Here are some others:

The principal conundrum. If you purchase a variable annuity, you are likely going to be locking in a return on your principal that provides virtually no chance of achieving returns in line with the benefit amount. And remember, your actual dollars are invested in the market and are subject to fluctuations. As this plays out over the seven-year surrender period in our example, you are likely going to end up with a benefit amount that is significantly higher than your walk away value. This isn't an accident. The large spread between the walk away money and the benefit base can make it emotionally difficult for investors to surrender a contract even when it might be in their best interest.

More high fees. You may be paying even higher costs, by percentage, than those we mentioned previously. This occurs because the rider charge (typically 1 percent) is applied to the greater of the benefit base amount or the walk away amount. Keep in mind, however, the benefit base is guaranteed to grow every year at a specified amount and frequently will outpace the walk away money. In our example, this means that the rider charge would be applied to the $703,550 at the end of the seven years. In other words, the rider fee alone would be $7,000 per year. The remaining 2.4 percent in fees are applied to the walkaway amount, or $574,000, which equals more than $13,000. All in, the fees on this contract in year seven exceed $20,000. Annually. As a percentage of your actual assets ($574,000), total fees of $20,000 represent a charge of 3.62 percent, not the 3.4 percent you would get by simply adding the individual fees together.

The impact of high fees on returns. Our example shows an expected rate of return of 5 to 5.5 percent and effective costs of 3.62 percent. Costs will continue to climb over the life of the contract because the benefit base is expected to grow faster than the rate of return earned by your invested dollars. That, in turn, increases the fees you are paying as a percentage of your walk away money. Expenses in this case turned out to be more than 60 percent of the expected rate of return, which can severely impact the growth of the walk away amount.

A lack of understanding. Variable annuities are very complex investment vehicles. The prospectus alone can be longer than 300 pages and are very difficult to understand. Do investors purchasing this type of variable annuity have the time to read and comprehend that amount of complicated material? Do they recognize that the guarantee is on the future income the contract will produce for them over the course of their lifetime, not on their principal? These insurance products do not guarantee a rate of return; you are only guaranteed to receive a specific income from the contract or a death benefit guarantee of the original investment. If investors truly need guaranteed income to accomplish their goals, are there better, lower-cost options available? Before purchasing any financial product, it's important to understand and take into consideration the pros and cons of the investment in addition to your willingness, ability and need to assume risk. This is critical because once you commit to a variable annuity, there are significant penalties if you change your mind during the surrender period.

Flexibility issues. Variable annuities with income guarantees are often billed as highly flexible financial instruments. That, however, isn't always the case. Sometimes they are promoted as a way to guarantee income without having to annuitize in certain situations (although this can also be an issue because some contracts force investors to annuitize in order to get the rollup benefit amount). And this may not be a real benefit after all. In the event your financial needs change and you require more income, variable annuities may prevent you from cost-effectively adapting your investments. Withdrawing more than the benefit base amount guaranteed in the contract may result in a loss of the guarantee. In some cases, you could even take the walk away amount, annuitize with another company and get the same or more income from somewhere else. The lack of flexibility in these products often makes that route difficult.

Tax disadvantages. Variable annuities with income guarantees could result in unfavorable tax treatment for taxable assets. Annuities are often sold as being tax advantaged because they are essentially deferring income. However, gains are withdrawn first and thus are taxed as ordinary income, not at the lower rate that dividends and capital gains are.

In conclusion, many investors simply do not need a guarantee of income if they have a low risk tolerance and little need to take on significant amounts of market risk. What's more, the costs associated with variable annuities are high. Finally, if investors do need guaranteed income, there are alternatives to variable annuities that may offer similar benefits with a lower cost structure.

About Jason Vande Brake, Wealth Advisor, Northwest Wealth Management, Spencer, IA

Growing up in Orange City, Iowa, Jason holds a Bachelor's Degree in Education from Drake University. With five years previous experience from Edward Jones in investments as well as coaching college basketball and serving as an Athletic Director, Jason strives to work closely with his clients and help them reach their financial goals.

Jason joined the Northwest Wealth Management team in October of 2012. Helping families and business owners to develop unique and customized strategies is Jason's expertise. Jason, his wife Danyelle, and two children Jaxson and Brooklyn reside in Le Mars, Iowa.