UNDERSTANDING **ANNUITIES**

They're not as Simple, Safe or Cheap as they Might Appear

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Helping others successfully navigate their financial journey in order to achieve their unique dreams and goals. We accomplish this through skillful analysis that is comprehensive, attentive and objective.

As an investment option, annuities sound like a smart choice: invest a sum of money either at one time or over a period of time, and receive a fixed amount of monthly income from it for a set length of time or even for life. This sounds a lot safer than investing in the ups and downs of an ever-changing financial market; this sure sounds like it removes the risk of investing and provides peace of mind for retirement.

But is that true?

The fact is, annuities are not as simple as they appear. They might look as though they are safer than other products that can drop in value, but annuities often come with sizeable costs, hard-to-decipher restrictions and other possible pitfalls to undermine their benefits. And when compared to the historical returns of other investment options, annuities pose a real risk to a secure retirement.

Let's explore the complexities of annuity investing, to help you decide if annuities truly make sense for your investment goals.

Three Types of Annuities

Annuities are not all the same. There are three key categories of annuities, each with its own risks and rewards. Choosing a particular type of annuity may be determined by your specific investment goal: that is, whether you are looking for income or growth.

The three primary annuity types are:

• **Fixed Annuities** – Typically, these guarantee a fixed or minimum rate of return for a given period of time. The upside is that you don't have to worry about losses thanks to the guarantee, but you might also earn similar returns through other less confining investment options.

• **Indexed Annuities** – These annuities deliver a rate of return linked to a particular market indicator, such as the S&P 500. However, it's not uncommon for these to come with a percentage cap on the market's return that the owner can collect. In addition, there are often other types of caps, restrictions and limits on what you can earn.

• **Variable Annuities** – With these, investors have some choice about where to invest their funds, similar to a mutual fund, and variable annuities can also provide a minimum guaranteed return even if the assets underperform. Note, though, that fees and other expenses often dilute your total return.

Annuity Expenses to Consider

It would be ideal to know there is a single flat fee that comes with annuities, but unfortunately most don't work that way. It's more common for them to have assorted fees – many times cleverly hidden from easy view – that add up to thousands of dollars each year.

Here are some examples of the most common fees associated with annuities (and what they cost using a typical $100,000 annuity):

Fee Description	Rate	Annual Cost
Mortality and expense charge	1.20%	$1,200
Administrative charges	0.20%	$200
Investment management fees	1.00%	$1,000
Rider charges	1.65%	$1,650
Total	**4.05%**	**$4,050**

This is not an exhaustive list of the potential extra fees and costs that can be imbedded in an annuity; there is no way to list all the possible fees. Each annuity contract, which can run 300 to 800 pages, must be read carefully to identify all the fees that will apply.

Fees of this level can easily compromise the benefit of the annuity and render the annuity useless in terms of actually helping you achieve your retirement goals.

The Ins and Outs of Annuity Riders

When annuities first were offered by insurance companies over a century ago, the basic premise was to ensure a person did not outlive his or her income. It was a simple proposition: the annuity buyer gave the insurance company a lump sum up front, and the insurance company provided an income stream for life. With time, annuities became increasingly complex as insurance companies offered more "bells and whistles" to attract buyers. These bells and whistles are called "riders." Riders are supposed to offer real additional benefits to the annuity buyer, but they often provide minimal economic benefit at substantial costs.

Adding riders is easy, but getting these benefits can be difficult. Some come with severely limiting conditions, and actions you may take early on can affect the income you receive later. Despite paying for a given rider, you might only benefit from it if your annuity has performed poorly, essentially requiring you to pay extra to guarantee a return you should have been able to count on in the first place.

Some of the most common riders you may choose, and pay for, include:

- **Guaranteed Minimum Withdrawal Benefit Rider** – You will receive a guaranteed minimum income stream, typically monthly, quarterly or annually, but only for a specific period of time, such as the contract's length or until the total amount you receive in income payments equals the principal value.

- **Guaranteed Lifetime Withdrawal Benefit Rider** – With this rider, you also receive a guaranteed stream of income, which is commonly a percentage of the principal, and the income stream lasts as long as you live, even if the total payments exceed your principal investment.

- **Guaranteed Minimum Income Benefit Rider** – This rider also guarantees an income stream for your entire life but the principal balance is typically forfeited after a predetermined maturity date. For example, it can require that 10 years after you purchased the annuity, you have to sell it for a lump sum value or exchange that value for a lifetime income stream.

And here are a few examples of restrictions and requirements that may come hand-in-hand with exercising your riders:

• **Annuitization** – Activating this rider requires you to convert the annuity into a stream of periodic payments, which is known as "annuitization." This typically means turning over the entire principal to the provider to receive a guaranteed cash flow, and you cannot revoke this decision. You lose all rights to the principal balance. If you die before your "income" payments equal your original investment, you will forfeit the remaining balance.

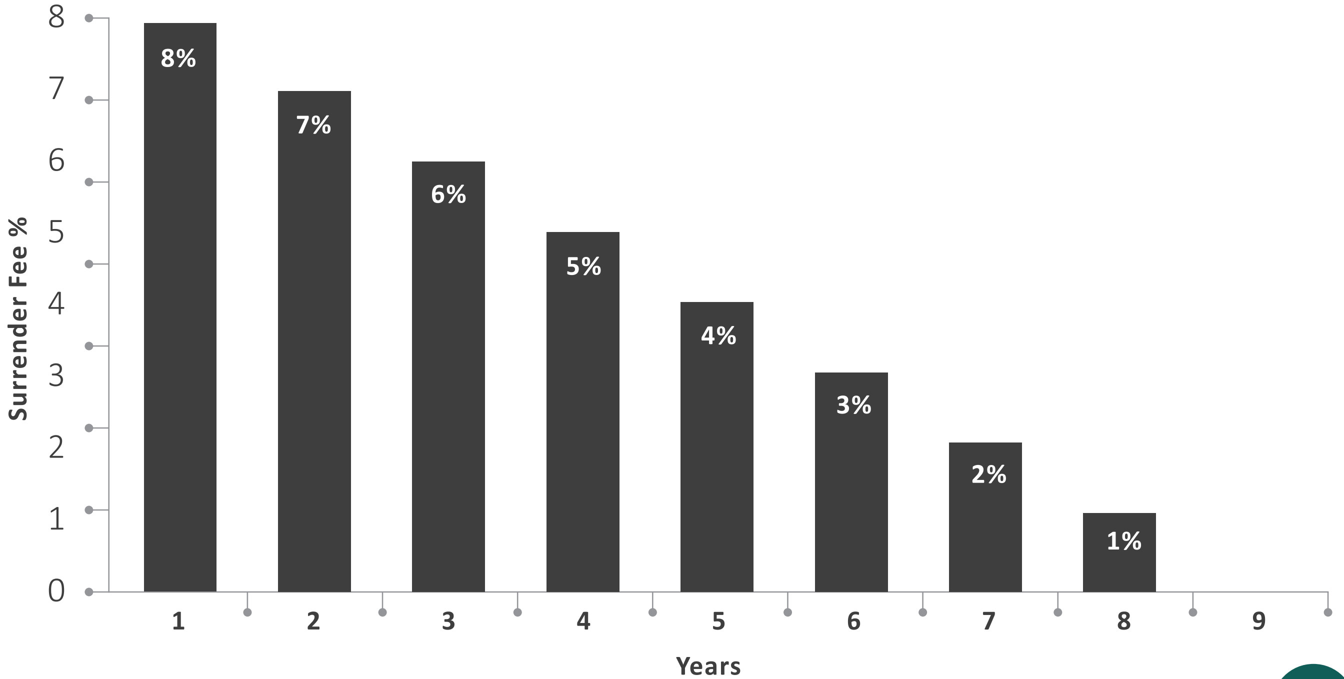
• **Waiting Period** – Frequently, a rider compels you to wait for a specified period before you can withdraw income and derive the full benefits you've been guaranteed, and that waiting period can be 10 years. Note, too, that this period of time is separate from the time in which you might incur surrender fees for withdrawing money. These factors are important to consider if there is a chance you would need the benefit sooner.

• **Fewer Investment Options** – Given that some living benefit riders guarantee a percentage income stream per year, some providers have begun to dramatically limit the options for investing your principal as a way to "control volatility," reducing equity exposure within an annuity. Managing their risk also means reducing the benefit from the guarantee you are paying for.

Penalties for Early Withdrawals

For the most part, investing in an annuity means you are agreeing to keep those funds committed for the length of the contract, which also means those assets are not available to you for unexpected needs unless you pay what's called a "surrender fee." These can be significant charges added (in addition to the fees discussed above) to the end of the annuity agreement, often starting at 8% and then declining each year as the annuity gets closer to its maturation.

Hypothetical Annuity Surrender Charges



Many annuities do promote the ability to make free annual withdrawals, but it's key to pay attention to the details. A small withdrawal may be allowed without penalty but if you to need withdraw a substantial amount after you've bought the annuity, the surrender charges will apply.

In addition, if your annuity is a fixed annuity, you might pay an early surrender fee as well as a "market value adjustment," which can negatively impact the remaining value of your asset in a time of rising interest rates.

An essential rule of thumb when purchasing an annuity is to be prepared to stick with your decision for six to eight years, or be ready to pay a penalty for the early withdrawal. There is variation in annuity surrender periods, so if you decide to purchase one, look for an annuity that meets your expected needs and has no surrender charges. Typically these annuities offer no commissions to the sales reps, and that's why you usually don't hear about them from insurance company reps, life insurance agents or stockbrokers – there's nothing in it for them.

As a side note, it can be a very interesting conversation to ask the rep (if you insist on working with one) what the commission rate is. You'd be surprised to learn how high it is – especially in the first year – and you'd understand why the surrender charge is so high. The insurance company has to pay the commission to the rep at the time of sale. The insurer forks over 5% or more and needs to have a substantial amount of time using your money to earn back what it pays the rep. Be sure to ask your sales rep what the commission is on each of several annuity products. Don't let the rep show you just one annuity. The commissions differ, and those differences usually impact which annuity product the rep recommends.

It's your right to know this information. If you're working with a true financial professional, he or she won't hesitate to tell you – so don't be afraid to ask.

Recap of Terms

Surrender Fee: a fee for withdrawing a substantial amount from the annuity earlier than allowed by the contract.

Market Value Adjustment: a potential additional cost charged if you withdraw substantial amounts early. It is meant to compensate the insurance company for adverse interest rate moves.

Commissions: the commission the sales rep receives at the time of the sale and then potentially throughout the life of the annuity contract. The commission is usually higher in the first year than during subsequent years.

Performance Restrictions

Given that annuities are often considered for investment purposes as a way to guarantee income while minimizing risk, it makes sense that many – most often, indexed annuities – come with minimums and maximums on their performance.

• A performance "floor" sets a minimum rate of return to be earned, while a performance "cap" determines a maximum return that would be paid monthly or annually.

Remember, the annuity provider will take your money and invest it somewhere. The floor is the minimum amount they promise to credit you regardless of how the investments in the annuity perform.

• The cap is the maximum they will credit you. For example, if the cap is 6% per year, and the market grows 7% that year, you will only receive credit for 6% growth; the insurance company will keep the remaining 1% in this illustration.

Another potential restriction is the participation rate. This restricts you to a certain share of the market's return. For example, if the participation rate is 70%, you only would be credited with 70% of the market gain up to the cap established.

Let's return to our earlier example above where the cap rate is 6% and the market gain was 7%. The participation rate changes the calculation a bit by adjusting the market gain before the cap rate is applied. 70% participation in the market gain of 7% is 4.9%. So, instead of being credited 6%, you would be credited only 4.9%.

Illustration of Potential Performance Restrictions	
Market Gain	7.0%
Cap Rate	6.0%
Potential Credit to Your Annuity Account	6.0%
Participation Rate	70%
Actual Credit to Your Annuity Account	4.9% (7% X 70% = 4.9%)

The rationale behind these performance restrictions represents the essential basics of the annuity "deal." In return for a more consistent income stream, you (the buyer) agree to give up some of the gains the insurance company can earn with your money. Floors do help protect investors from major losses when the market tumbles, but caps and participation rates protect the insurance companies. They will never have to share all the gains they make by investing your money.

This deal seems good to lots of annuity buyers. And it may be the right move for some – but most people do not understand how high the costs are. In these situations, costs have to be understood as the gains you're giving up for the downside protection.

The key here is what you could have done with your money. Since the typical annuity buyer is purchasing the annuity to avoid the volatility of the stock market, it makes sense to look at what the buyer could have earned in the stock market if he or she had been willing to put up with the volatility.

A Closer Look at Returns

We hope this makes sense but let's explore it further, just in case. If you're trading risk for consistent income, then you should understand what you could have earned if you had been willing to take the risk. Instead of buying the annuity, you could put your money in a very broad index fund, which replicates the S&P 500. Yes, you'd experience all the volatility of the S&P – and there has been a great deal of volatility – but you would have also earned all the gains of the S&P 500. We can always pick and choose short time periods to skew the results, but we want to make as honest a comparison as we can.

We can point to various time periods to determine the average annual return of the S&P 500:

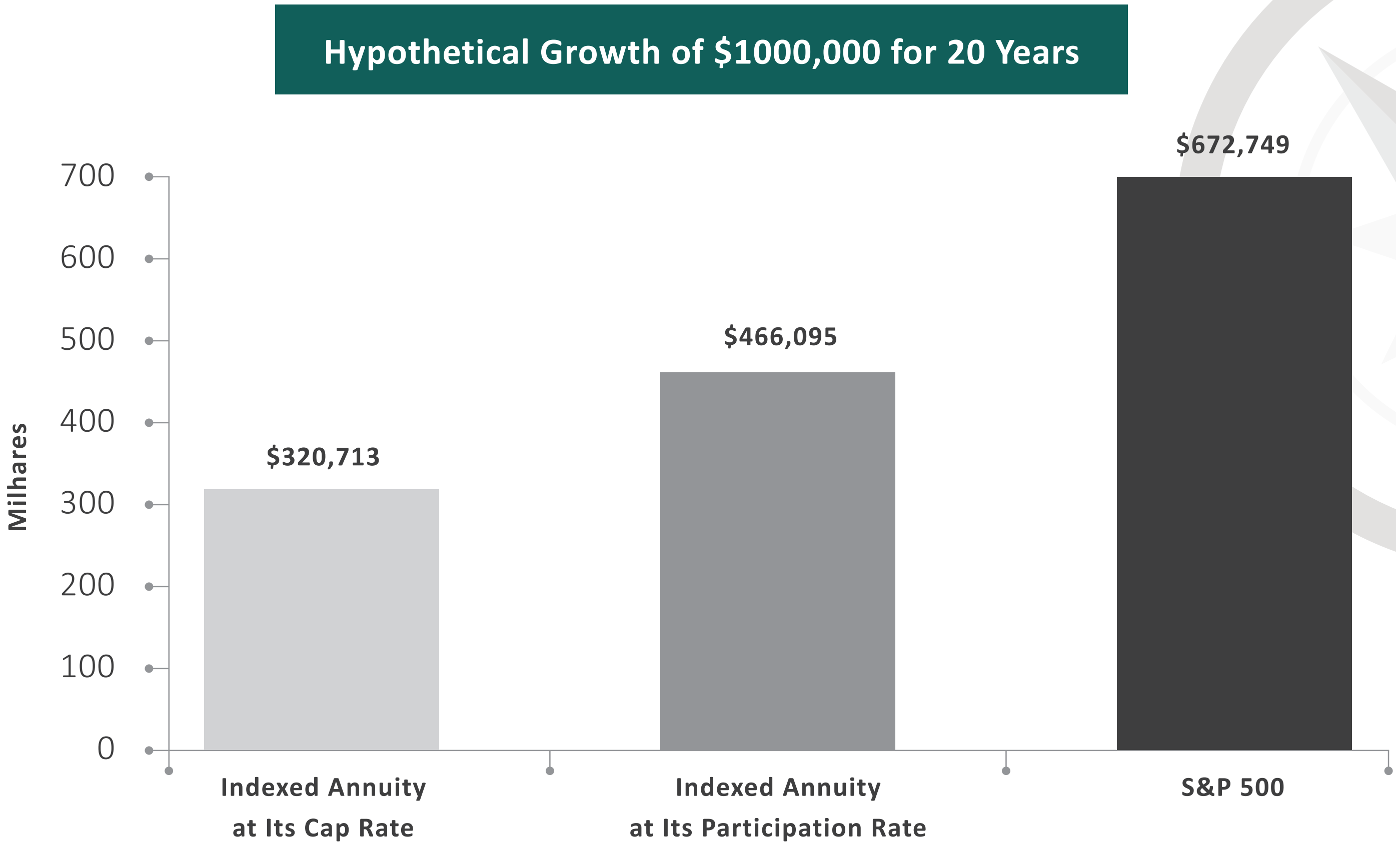
25 years (1992 – 2016)	10.7% average per year
30 years (1987 – 2016)	11.6% average per year
10 years (1990 – 1999)	18.0% average per year

We could go on for a long time, quoting many different periods. To be honest, let's look at the very, very long term as our guide. The average annual return of the S&P 500 from 1917 to 2017 (100 years) was 10.2%.

So we'll use 10% as our comparison. If you had been willing to accept the volatility of stocks, we'll assume you could reasonably expect to earn 10% average per year. This is the same 10%, by the way, which the insurance companies could earn with your money in an indexed annuity.

They would take your money and invest it in the market, and in exchange you would receive an indexed annuity. To get a flavor for how much this might cost you over 20 years, we'll assume the insurance company would offer you an 80% participation rate and a max of 6% per year.

Here's what the comparison looks like.



As you can see, the cost in terms of lost earnings over the 20 year period of this illustration is substantial:

• You would have lost $206,654 if we compare investing directly in the S&P 500 against the amount you would have earned based on the annuity participation rate ($672,742 - $466,095).

• You would have lost $352,029 if we compare investing directly in the S&P 500 against the amount you would have earned based on the annuity's cap rate ($672,742- $320,713).

It bears repeating: annuities offer you a trade-off – a consistent income stream in exchange for giving up potential earnings. Nothing in this guidebook is meant to contradict that.

However, few people understand the true magnitude of the cost paid for that consistent income stream.

$100,000 invested over 20 years (based on the long-term reasonable return of the S&P 500) could have shown this investment grow to $672,749. That is the starting point for discussions about annuities. The more risk you ask the insurance company to take onto their shoulders, the more they take away from your potential earnings.

The drawbacks of these caps and participation rates, all of which benefit the insurance company, can easily overwhelm the benefits of floors that insulate investors from temporary bear markets.

The amount you'll earn on your annuity will likely be similar to a Certificate of Deposit. The loss of potential growth for your hard-earned savings may be sizeable and real.

Tax Implications of Annuities

It's imperative that you discuss the possibility of purchasing an annuity with your tax advisor to understand the tax treatment, particularly because unwinding an annuity purchase can be difficult and costly. Should you later discover you aren't getting the tax treatment you want and you try to cancel the annuity, the surrender charges discussed above would apply.

Let's explore some basic tenets of annuity taxation to help you decide whether an annuity is your best option.

An annuity is an insurance contract, and it is therefore given tax-deferred status. The earnings and growth inside the annuity (before they are withdrawn) are not subject to income or capital gains taxes. Unlike other tax-deferred retirement accounts, such as 401(k)s or IRAs, there is no annual limit on the amount you may invest in an annuity.

However, when money is withdrawn from the annuity, some portion of each withdrawal is treated as if it is a return of your principal – and therefore is not taxed. At the same time, some portion of each withdrawal is treated as if it is part of the gain inside the annuity.

The taxable portion of the annuity withdrawal will be treated as regular income, not as capital gains. Depending on your income tax rate and capital gains tax rate, this may not be the tax treatment you want.

There have been times in this country's tax history when income tax rates have been twice as high as capital gains tax rates. During these times (and the odds are you will experience this during your lifetime), you will want to minimize annuity income. Unfortunately, annuities won't let you switch between regular income and capital gains. You'll be stuck paying the higher tax rate on your retirement income.

Because of this, most objective advisors recommend that you take full advantage of all other tax-deferred options such as 401(k)s and IRAs before you purchase an annuity.

Sadly, annuity sales reps have found a way to compound this problem by convincing people to purchase annuities through their retirement accounts. There are no significant benefits to doing this.

Why do sale reps focus on convincing people to use their IRAs to purchase annuities? They do it because that is typically where people have accumulated their largest pool of money. If you've planned well for retirement, you will likely have a sizeable IRA or 401(k) account balance. But here's the rub: IRA and 401(k) accounts already provide you with a tax-deferral benefit! Money accumulated in them is protected from tax. You do not get an additional tax benefit by buying an annuity inside an IRA or other retirement account.

In fact, you may actually increase your penalties and fees if you purchase an annuity through your retirement account – if you withdraw the money too early. If you need to withdraw money before the annuity surrender period has expired and prior to age 59 ½, you would pay surrender charges that are sometimes as high as 8% (which have been discussed above) AND you would pay an early withdrawal tax penalty of 10% to Uncle Sam, along with perhaps an additional amount to your state's tax agency.

That's right. If you own an annuity inside your retirement account, the penalties for early withdrawal are imposed ON TOP OF any surrender charges. Simply put, buying and holding an annuity inside your retirement account is a tremendously bad idea. You receive no extra benefits, you pay higher annual expenses, and you potentially incur double penalties for early withdrawals.

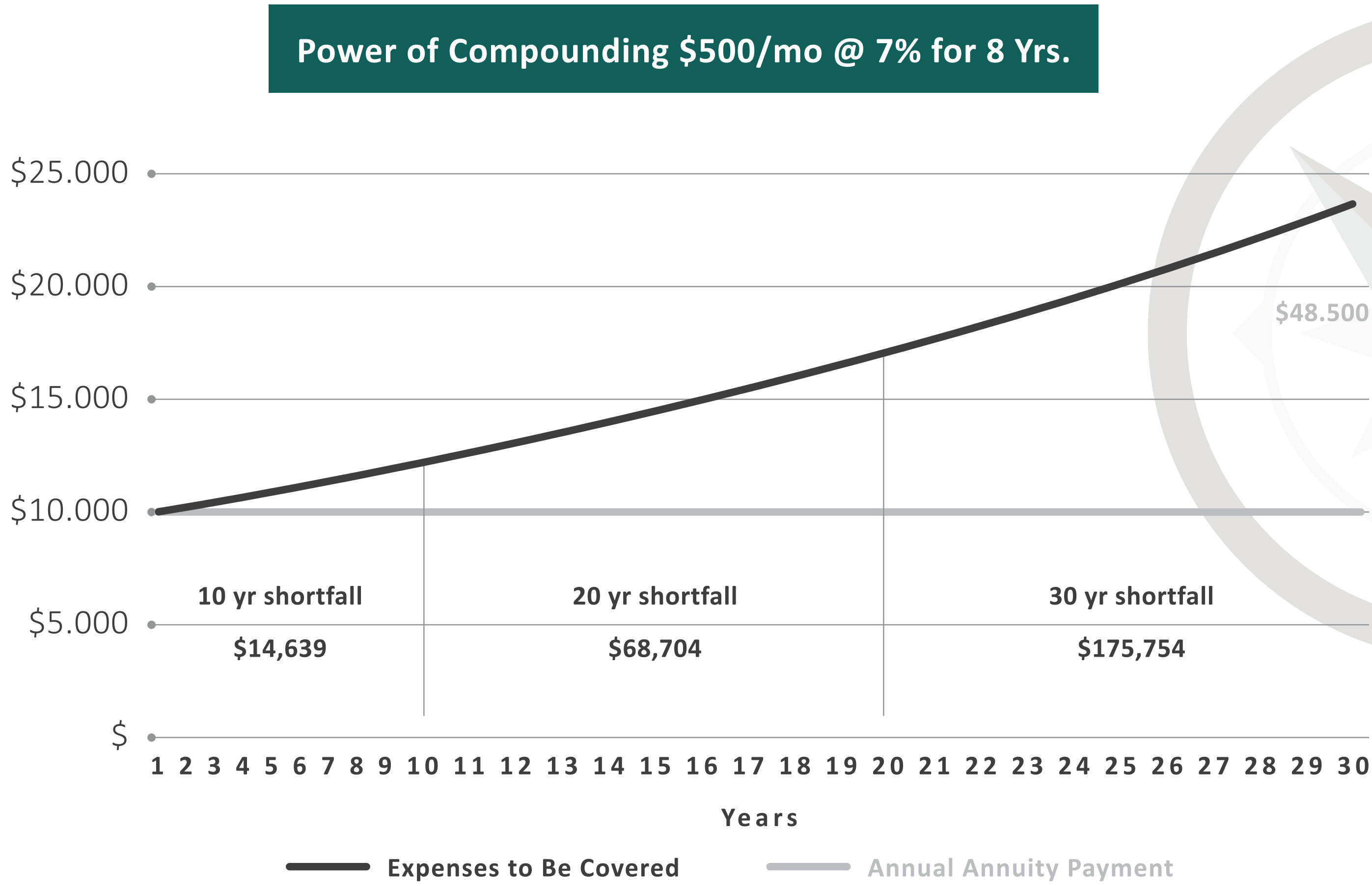
The Impact of Inflation

Investors interested in annuities often are looking for a way to be sure they don't outlive their assets. Too often, people forget to think about the risk of inflation and the associated lack of protection for their assets as costs rise while fixed income remains fixed. Social Security payments are not sufficient to meet most Americans' needs in retirement, but at least they are pegged to the inflation rate, usually delivering very slightly increased payments each year.

Annuity income, on the other hand, typically is not adjusted for inflation, and this can be deadly to your long-term financial future.

Let's say you incur $10,000 each year in living expenses that won't be covered by your Social Security payments or other pension/retirement income. Now, let's say someone offers to sell you an annuity that will immediately begin paying you $10,000 per year. So far so good: in the first year, you needed an extra $10,000 to cover expenses, and the annuity paid you $10,000.

But what happens after the first year? What happens when inflation – even a relatively small 3% per year – hits in the second year, and the third, fourth, and thereafter? The graph below demonstrates the shortfall that would be created over 10 years, 20 years or 30 years.



The chart makes clear that while the differences between the inflation-adjusted living expenses and the constant annuity payment are slight in the beginning, they grow quickly to a significant level.

Over the course of 10 years, the difference is already pronounced; over 20 years, it is critical, and the difference over 30 years could be devastating. If you do not properly anticipate the cost of your living standards increasing with inflation, and if you are relying on annuity payments for a sizeable portion of your retirement income, you may well find yourself having to cut back and/or downsize at a time in life when you thought you'd be able to relax and enjoy your retirement years.

Some annuity contracts do offer a feature to adjust for inflation – but beware, these plans usually reduce early-stage annuity payments by 20-30%, depending on your age, when compared to fixed payment annuities. In such cases, you might find that you're just running deficits in the early years instead of the later years.

Annuities After Death

While mortality is never a pleasant topic, knowing what will happen to your annuity after you're gone is an important consideration. Annuities usually provide a number of options for death benefits, but once again it is important to review these choices in the context of your estate plan and with your tax consultant.

In many instances, the annuity payment option you select may reduce or eliminate any death benefit. A careful reading of the tradeoffs between the various income payment options is an absolute requirement.

Your beneficiary(ies) also may have a number of options when accepting the death benefit, such as payment of a lump sum, regular disbursement payments, deferring receipt of the death benefit, or simply taking over ownership of the contract if a surviving spouse, for example. Many of these options or restrictions will likely depend on whether your beneficiary is a spouse or non-spouse.

The “Guaranteed Minimum Death Benefit,” which may be built into the contract or deliver enhanced benefits through an added-cost rider, ensures that your beneficiary receives either the amount that was invested or the value of the contract on its most recent policy anniversary – whichever is higher. For example, if you passed away while the market was considerably down, the value of your annuity at that particular moment could mean a loss for your heirs if it were a straight transfer. With this safeguard, your heirs won’t be shortchanged.

From a tax perspective, however, one very important factor to keep in mind is that most variable annuities don’t receive a step-up in cost basis when you pass away and your heirs inherit your assets. This is another way in which annuities are different than other types of financial instruments.

“Cost basis” is a fancy accounting term to describe the portion of something that isn’t taxed because it is the price you paid for it. For example, if you pay $100,000 for an annuity, then your cost basis is $100,000. When you begin withdrawals, that portion of the annuity value will not be taxed. If, when you begin withdrawals, the value of your annuity has grown to $150,000, then the taxable gain (remember it’s treated like regular income) in your annuity would be $50,000.

Here’s a break down of all those numbers in this illustration:

Annuity Value When Withdrawals Begin:	$150,000
Total Cost of Purchasing Annuity (Cost Basis):	$100,000
Taxable Gain in the Annuity:	$500,000

When your heirs take over the annuity, they also take over your cost basis. So, the taxable gain remains the same for them as it was for you. If they had received a stepped-up cost basis (which other investments typically receive), the cost basis of the annuity would be reset – “stepped up” – to the value on the date of your death, reducing their tax liability.

Illustration of What Would Happen If Your Heirs Received A Stepped-Up Basis

	Values Without Step-Up	Values With a Step-Up
Annuity Value When Withdrawals Begin:	$150,000	$150,000
Total Cost of Purchasing Annuity (Cost Basis):	$100,000	$150,000
Taxable Gain in the Annuity:	$500,000	$0

Annuities will NOT receive a step-up in basis. The illustration shows what could have happened if they did get a step-up.

If you had purchased almost any other investment product for the same $100,000 and seen it grow to $150,000 at your death, your heirs could have received the step-up in cost basis, and they would be able to avoid taxes on the full value at the date of your death.

The lack of a step-up in cost basis means that annuities can easily create unexpected tax burdens for your beneficiaries when they take possession of the proceeds.

Understanding the Fine Print and Seeking Objective Advice

Signing a contract to purchase an annuity is perhaps one of the most important financial decisions in your life. It is essential to read every single word, very carefully.

- Don't sign it if you haven't read it!
- Don't sign it if you don't understand what you read!

There is no other way to view this important step. After a meeting – or several meetings – with an annuity sales rep, you may be tempted to tell yourself you understand annuities. Your desire to avoid reading and understanding the details will be even stronger when you see how thick the prospectus and contract are.

You cannot skip this step. No matter what any sales rep tells you, the only way to determine if an annuity is the right choice for your investment goals is to read these documents. You need to understand the annuity's restrictions, conditions, costs and payouts.

Don't be shy about asking questions, but we strongly advise that you ask an objective advisor these questions. There will be a great deal of surplus jargon and technical features that the average investor simply cannot understand sufficiently. The sales brochure will likely be designed to hide or obscure the annuity's costs and limitations, and prospectuses are notoriously boring with specialized information that can make anyone's eyes glaze over.

This is especially true for variable annuities but even the shorter contract that's typically associated with indexed annuities can confuse and disguise features that are essential to understand.

In particular, look to see if the annuity provider reserves the right to change terms. This can make a material difference to you: fees, participation rates, performance floors and caps may change, and your overall return on your investment will be affected.

You may have intended to make continued contributions to your annuity so that your income benefits would be greater, but some providers choose to limit additional contributions to limit their benefit payouts. So remember: once you sign that contract, it is not an easy or inexpensive task to get out of it.

Lastly, always remain focused on your ultimate investment goal – achieving financial security for a comfortable retirement. There is no investment, insurance policy, annuity or mutual fund that is necessarily good or bad inherently. The usefulness of each one depends on your unique situation. Take the time to properly assess where you are, where you want to go, and how to best make that journey.

You don't have to be alone in that process. There are many good, honest and 100% objective advisors who can help you. They don't sell any product; they don't receive commissions; they don't have any economic incentive to mislead you. They have every incentive to help you determine what is truly in your best interest.

First Financial Consulting is one of these 100% objective advisors. If we can help you with any of your planning or retirement needs, questions or concerns, please give us a call or send us an email. We're here to help, and initial consultations are always free.